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Program Preservation, Evolution, and Financial Change: Finances and Fundraising Asset Transfer Considerations

Economic conditions and other challenges may cause many New York nonprofits 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 not-for-profit 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 an asset transfer?
2. What constitutes a transfer of “substantially all” assets?
3. What if the underlying assets are subject to donor restrictions?
4. What are the mechanics of the transfer or sale of assets?
5. Are there any special considerations if the nonprofit organization is in severe financial distress?
6. 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 organization 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 an asset transfer?

When a charitable not-for-profit corporation formed under New York State law is selling, leasing, or otherwise disposing of all or *substantially all* of its assets, it will be required to get authorization from the New York State Attorney General (the Attorney General) or the New York State Supreme Court (the Supreme Court), with notice to the Attorney General.¹ A corporation may seek approval directly from the Attorney General, unless the corporation is insolvent or would become insolvent as a result of the transaction, or if the Attorney General, in his or her discretion, concludes that a court should review the

¹ New York Not-for-Profit Corporation Law (“N-PCL”) §§ 511 and 511-a.

petition and make a determination.² Transactions by non-charitable not-for-profit corporations do not need Supreme Court or Attorney General approval.³

To approve the transfer, the Attorney General or the Supreme Court must find that (1) the consideration given and the transaction terms are fair and reasonable to the not-for-profit corporation and (2) the transaction promotes the purposes of the corporation or the interests of its members.⁴ Another important consideration is that the proceeds of the asset transfer must be used in a manner that is consistent with the nonprofit's charitable purposes. The proceeds may not be used for the personal benefit of a director, officer, employee, member, or any other interested party.⁵

2. What constitutes a transfer of “substantially all” assets?

There is no exact formula to determine “substantially all” of a nonprofit organization's assets. According to the Attorney General:

There is no fixed numerical or arithmetic measure of “all or substantially all.” Approval of the Attorney General or the Court is required when the transaction involves a large proportion of the corporation's total assets or when it may affect the ability of the corporation to carry out its purposes, regardless of the percentage of the corporation's total assets that are the subject of the transaction.⁶

The rule of thumb is that “substantially all” is considered to be 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 Attorney General or the Supreme Court looks to see if a particular asset is the organization's most valuable possession. In determining the value of the asset, the Attorney General or the Supreme 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 nonprofits have assets whose use is restricted to specific purposes by donors. The nonprofit organization must therefore use the restricted assets in a manner that is consistent with the directions of the donor. The Attorney General or the Supreme Court will exert its authority to review and possibly disallow any transfer of an asset where restrictions would not be honored or the asset would be rendered unusable by the transaction. When making this determination, the Attorney General or the Supreme Court may seek to apply either the judicial *cy pres* or the quasi-*cy pres* doctrines to the proposed asset transfer. The *cy pres* doctrine (meaning “as near as possible”) involves probing the

² N-PCL § 511-a.

³ Office of the Attorney General,

A Guide to Sales and Other Disposition of Assets Pursuant to Not-For-Profit Corporation Law §§ 510, 511 And 511-a at 4. Available online at: https://ag.ny.gov/sites/default/files/regulatory-documents/sales_and_other_dispositions_of_assets.pdf.

⁴ N-PCL §§ 511(d) and 511-a(c).

⁵ Office of the Attorney General,

A Guide to Sales and Other Disposition of Assets Pursuant to Not-For-Profit Corporation Law §§ 510, 511 And 511-a at 8.

⁶ *Id at 4.*

original intent of the donor to ensure the asset's continued use aligns as closely as possible with that intent. The slightly more lenient quasi-*cy pres* doctrine requires the asset to be used for purposes that are *substantially similar* to the purpose for which the asset was originally given. The quasi-*cy pres* standard entails a five-factor analysis: (1) whether the asset was received through public solicitation or under the specific dictates of a trust or will; (2) what the nonprofit organization's certificate of incorporation states that its purposes and powers are; (3) what services and activities the nonprofit organization actually provides; (4) what the activities and purposes are of the entity that will receive the asset; and (5) the reasons why the Board recommends the asset transfer.⁷ Thus when contemplating an asset transfer, the Board must consider not only how the nonprofit organization'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.

Further, donor-restricted assets should not be pledged to creditors as security. The Attorney General or the Supreme Court 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 organization to liability for fraudulently representing that the asset is available to the lender.

With respect to institutional funds (i.e., funds donated to an organization for the purpose of making investments rather than carrying out a programmatic purpose), there are a few ways in which a donor restriction can be lifted. The organization can seek a release or modification of the restriction from the original donor.⁸ If the donor cannot or will not remove the restriction, the organization may petition the Supreme Court to do so if the restriction is impracticable or wasteful, if it impairs the management or investment of the institutional funds, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the funds.⁹ The Supreme Court may also use the *cy pres* or quasi-*cy pres* standard to modify the restriction in a manner that is consistent with the purposes set out in the original gift.¹⁰ If the donor-restricted asset is less than \$100,000 and more than twenty years old, the restriction may be released through an application to the Attorney General without court approval or donor consent.¹¹

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

A nonprofit organization 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 Supreme Court or the Attorney General 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

⁷ In Matter of Multiple Sclerosis Serv. Org. of N.Y., 68 N.Y.2d 32 at 35.

⁸ N-PCL § 555(a).

⁹ N-PCL § 555(b).

¹⁰ N-PCL § 555(c).

¹¹ N-PCL § 555(d).

should be prepared by a professional appraiser who is completely independent from both the buyer and seller.

Step 2: Obtain board and membership approval

If the nonprofit organization has voting members, the board must adopt a resolution recommending the transaction and submit the resolution to the members entitled to vote.¹² The resolution must specify the terms and conditions of the proposed transaction, including the consideration to be received by the nonprofit and the eventual disposition to be made of such consideration, together with a statement addressing whether the dissolution of the corporation is contemplated thereafter.¹³ Once the voting members receive this information the transactions must be approved by 2/3 of the nonprofit's membership at an annual or special meeting of the members.

If the organization does not have members entitled to vote on the transaction, the transaction must be approved by at least a 2/3 affirmative vote of the entire Board.¹⁴ If the Board is comprised of 21 or more directors, a majority affirmative vote of the entire Board will satisfy the requirement.¹⁵ 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 "related party transaction" rules.¹⁶

Step 3: Draft the petition

Following Board and membership approval, the nonprofit organization must draft a petition for submission to the Attorney General or to the Supreme Court that details the terms of the transaction and places the transaction in the context of the nonprofit's overall activities.¹⁷ Required contents of a petition for the Supreme Court are outlined in N-PCL § 511, and required contents of a petition to the Attorney General are outlined in N-PCL § 511-a.¹⁸ 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.

If the proposed transaction requires approvals by government agencies (such as the NYS Department of Health, NYS Education Department, etc.), such approvals must be obtained and annexed to the petition.¹⁹ Furthermore, if the nonprofit organization is delinquent in its required filings with the

¹² N-PCL § 510(a)(1).

¹³ *Id.*

¹⁴ N-PCL § 510(a)(2).

¹⁵ *Id.*

¹⁶ N-PCL § 715.

¹⁷ N-PCL § 510(a)(3).

¹⁸ See also, in addition to sample petitions, Office of the Attorney General, *A Guide to Sales and Other Disposition of Assets Pursuant to Not-For-Profit Corporation Law §§ 510, 511 And 511-a* at 9.

¹⁹ *Id.* at 13.

Attorney General, the organization will have to make its registration and reports current before it can receive authorization for the transaction.²⁰

Step 4a: Submit the petition to the Supreme Court and have a hearing on the petition

If the petition is filed with the Supreme Court, the petition should be filed with the New York Supreme Court of the judicial district or county court in the county where either (i) the nonprofit organization has its office or (ii) the principal place where the mission of the nonprofit is to be carried out.²¹ Upon receipt of the petition, the Supreme Court shall direct that at least 15 days' notice²² be given to the Attorney General and any other interested person (as determined in the Supreme Court's discretion) setting the time and place for a hearing for the application. If the nonprofit is insolvent, all of its creditors must be given notice of the hearing.²³

If the Supreme Court is satisfied that the consideration and terms of the proposed transaction are fair and reasonable to the nonprofit organization and that the purposes of the nonprofit or the interests of the members will be promoted, it may authorize the asset transfer and issue a signed order directing the transaction to occur.²⁴

Step 4b: Submit the petition to the Attorney General

Alternatively, in lieu of obtaining Supreme Court approval, the nonprofit may submit the petition to the Attorney General for approval unless the corporation is insolvent, or would become insolvent as a result of the proposed transaction, in which case notice to all creditors and a petition to the Supreme Court would be required.²⁵ Additionally, the Attorney General may determine in his or her discretion that the Supreme Court should instead review and make a determination regarding the petition.²⁶ The Attorney General may, in his or her discretion, direct the nonprofit organization to provide notice of the petition to any interested person, in which case it must provide a certification to the Attorney General that such notice was provided.²⁷

If the Attorney General is satisfied that the consideration and terms of the proposed transaction are fair and reasonable to the nonprofit and that the purposes of the nonprofit organization or the interests of the members will be promoted, the Attorney General may authorize the asset transfer and direct the disposition of the assets as described in the petition.²⁸ At any time, including if the Attorney does not approve the proposed transaction, or if the Attorney General determines that Supreme Court review is appropriate, the nonprofit organization may seek court approval as described in Step 4a above.²⁹

²⁰ *Id.*

²¹ N-PCL § 510(a)(3) and 511(a).

²² The Supreme Court may shorten this time period to fewer than 15 days upon a showing of good cause. N-PCL § 511(b).

²³ N-PCL § 511(c).

²⁴ N-PCL § 511(d).

²⁵ N-PCL § 511-a(a).

²⁶ *Id.*

²⁷ N-PCL § 511-a(b).

²⁸ N-PCL § 511-a(c).

²⁹ N-PCL § 511-a(d).

Step 5: Receive authorization for the transaction

Whether through a Supreme Court-issued signed order or from an authorization from the Attorney General, once approved, the nonprofit organization may proceed with the transaction. Note that if the transaction involves real estate, the title company or others may require a copy of the order or authorization as a condition precedent to closing.

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

Even if a nonprofit organization is insolvent or is in severe financial distress, it cannot transfer all or substantially all of its assets without considering the above-mentioned statutory requirements of the N-PCL. If a transfer of all the nonprofit organization'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 organization 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 organization is insolvent, the process of obtaining the Supreme Court's approval will also require additional time. As noted, creditors of a distressed nonprofit organization must be given notice of the proceedings and the opportunity to appear and explain why the transfer should not be approved.³⁰ If the nonprofit organization has already sought protection from its creditors under the federal bankruptcy law, 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 charitable not-for-profit corporation under New York law. Additionally, as stated above, if the nonprofit organization is insolvent, the petition can only be made to the Supreme Court, not to the Attorney General.³¹

6. 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 directors make an effort to understand the terms of the transaction. If not, an action may be brought against an individual director to account for his or her conduct in neglecting to fulfill his or her duties. In addition, the transaction may be set aside by the court and an injunction may be obtained to prevent the transaction from occurring. For this reason, it is imperative that Board members fully disclose any potential interest in a proposed transaction before seeking the approvals outlined above.

³⁰ N-PCL §511(c).

³¹ N-PCL §511-a.

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