

## **Asleep at the Wheel: A Not-for-Profit Board of Directors Confronts Insolvency**

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*Not-for-Profits (NFP) play an important role in the United States. Boards of Directors are integral components of governance associated with NFPs. This case discusses some of the financial issues with which the Board must be both aware and diligent. Students are encouraged through the case discussion of the demise of the NFP to identify errors the Board made and suggest actions the Board could have taken.*

### **INTRODUCTION**

As corporate management scandals and ethical failures recur at the highest levels of leadership, public awareness of the basic practices of governance becomes more important. One critical aspect of Governance is the functioning of the Board of Directors which oversees the general well-being of the institution, sets the broad policies and objectives, and determines the availability of appropriate funding. Since Not-for-Profits (NFP) often involve community volunteers who serve on the Board of Directors, improved awareness may make for better governance by increasing the pool of better informed individuals available to serve on the Boards, such that the Boards themselves become more effective.

Board members come from many backgrounds with varied skill sets, but frequently feel unable or unprepared to deal directly with the financial concerns of the operation. Therefore, it becomes necessary to encourage Boards not to delegate the control of checks and balances within their financial system to management, but for the members themselves to remain involved in the review process. The board is the ultimate responsible agent for the integrity of its financial practices. In *The CPA Journal* (72 (3), 2002), H. S. Grace Jr. and his associates state “The board with and through its audit committee must accept the ultimate responsibility for the quality and integrity of the risk and control environment” (p. 64).

Boards set policy that governs the work and the membership of the various committees involved in the governance of the organization. The entire board should monitor the work of these committees, such as discussing and analyzing the financial reports. Attention must be paid to funding, expenditures, revenues, debt and cash flow. Board members should become familiar with these terms and concepts. The Audit Committee is the agent of the Board responsible for financial reporting and disclosure. There are

opposing views as to whether or not the Audit Committee needs to be composed of only experienced and financially skilled individuals. H. S. Grace et al. (2002) argue "...improved checks and balances requires the board, the audit committee, senior management, the internal auditor and the external auditor to closely examine their role, responsibilities and relationships so that collaboration increases" (p. 64) and general governance of a healthy organization is achieved.

DeZoort & Salterio (2001) argue that "...audit committees can only be effective if they are independent of management and composed of individuals who possess adequate financial experiences." One or more volunteers from the community with accounting experience placed on the audit committee may resolve this issue if such a volunteer is available. As John Biggs, who served as President of TIAA-CREF, states in his testimony to the U. S. Senate Committee on Banking, Housing, and Urban Affairs (2002), the entire financial reporting process is fragile, relies on the integrity of all parties and some will have to have the courage to take a stand when questions should be asked.

The following sections describe the NFP and its financial difficulties. Section One provides a description of the operation and programs offered by the NFP, DEDC. Section Two summarizes the history of performance for the NFP as it slides into financial difficulty. Section Three includes the financial challenge with which the Board is faced and the questions for discussion. Section Four provides the teaching notes. Appendix 1 is an overview of the NFP structure and operation within New York State, while Appendix 2 is the epilogue describing of the eventual demise of the NFP.

## **DOWNTOWN ECONOMIC DEVELOPMENT CORPORATION (DEDC)**

### **Description**

Social service providers in the United States constantly struggle with the dynamic of delivering critical services to those in need within the confines of very limited budgets. There are times when this struggle leads organizations to incur significant liabilities and to slide into insolvency. The method with which the Board of Directors chooses to address this financial crisis dictates whether the agency and its programs will survive. The Board has chosen you as a financial analyst to investigate ways in which to improve both the financial condition and the performance of the Board of Directors which was unaware of the five-year slide into fiscal disaster.

On March 20, 1975, DEDC was incorporated as a Not-For-Profit Corporation pursuant to section 202 of the Not-For-Profit Corporation Law (N-PCL) of the State of New York. On July 14, 1976, the Internal Revenue Service determined the DEDC to be a tax-exempt corporation pursuant to section 501(c)(3) of the Internal Revenue Code. The mission of the DEDC is to develop and coordinate programs to address physical deterioration and improve investment in the Downtown Area of Brooklyn, New York. DEDC has a thirty-four (34) year history of upgrading the housing stock [1975-2009], revitalizing commercial activity and job creation, while recently expanding into providing education and support services for community residents. For the first thirty (30) years of operation, DEDC grew steadily attracting additional funds as the benefits derived from its operation were increasingly evident in the community. In the recent 10 years of that 30 year period [1996-2006], the funds raised averaged about \$1.7 million per year.

### **Programs Offered**

DEDC provides community assistance traditionally in *Housing Development and Assistance* and *Economic Development*; and has more recently expanded into providing programs for *Youth Development*, *Immigration Assistance*, and *Neighborhood Promotion and Community Building*. DEDC's ***Housing Development*** programs are designed to preserve the neighborhood's stock of apartment buildings from becoming abandoned and has been responsible for restoring over 3,000 deteriorated units in the Downtown area. Additionally, DEDC conducts workshops and provides individual counseling services for tenants, landlords, co-op owners and homeowners designed to keep the community and housing stock stable and protect it from rapid turnover and deterioration. DEDC also administers a fuel co-op program designed to make low cost energy available to homeowners in the community. DEDC's work in the area of ***Economic Development*** has been targeted towards aiding small business owners to

improve the attractiveness and viability of neighborhood commercial strips, while purchasing and demolishing abandoned buildings to improve and better safeguard these neighborhoods.

DEDC's *Youth Programs* are designed to offer positive alternative activities for at-risk teens and after school programs for young children. Included are (a) after-school programs at three neighborhood schools during the school year serving over 800 children, (b) an evening activity center serving over 200 teen-aged youth, and (c) a street outreach program designed to provide positive alternatives for at-risk teen-aged youth. In addition, DEDC's General Equivalency Diploma (GED) program serves 200 people under the age of 24 each year.

DEDC's *Immigration Assistance Programs* offer employment counseling, housing and social services information to immigrants. Assistance is available in English, Spanish, Chinese, Vietnamese, Haitian Creole, Cambodian and Cantonese. And, DEDC's *Neighborhood Promotion and Community Building* initiatives promote the Community and help to build relationships and understanding among the diverse ethnic groups who reside in Downtown.

In 2004, DEDC hired a new Executive Director with previous experience in non-profits by managing outreach programs for social services. In 2006, DEDC began to expand into additional social services involving child care, summer camp programs, community socials, as well as educational and cultural trips. These programs are currently heavily subsidized by DEDC's traditional fund raising sources. As such, fees collected for these services, as for the more traditional services, are priced to make the events affordable to the inner city, lower income residents.

## SLIDE INTO FINANCIAL DIFFICULTY

### Background

Beginning in 2006, DEDC experienced cutbacks in its government funding on both the state and city level. Many of these cutbacks were the result of local government agencies reacting to the Executive Director's decision concerning the use of funds from previously funded programs. In particular, the Director used funds intended for specific programs to support other services he had introduced to the NFP. Such mismanagement went undiscovered by DEDC's Board of Directors despite the fact that they were a talented and devoted group of volunteers. Several were wealthy individuals who enjoyed being able to volunteer their time for community service. Although the Board did not meet frequently, they did meet at least twice each year to view reports provided by the Executive Director, who also served as the Chief Financial Officer (CFO). The Executive Director provided a Summary Statement of Financial Condition (Table 1) as his report to the Board of Directors. The Executive Director used the Income Statements (Table 2) and Balance Sheet (Table 3) on file with State Agencies and the IRS to produce the summary statement (Table 1) for his report to the Board.

### Tax-Exempt Status

Nonprofits, or Not-For-Profits (NFP), receive exemptions from federal and state income taxes, pursuant to Section 501(c)(3) of the Internal Revenue Code and as such are often referred to as "501s." Once designated as a NFP, the organization is free from paying taxes on all income from activities related to the nonprofit's purpose. In addition, the NFP status enables the organization to attract donations or contributions to its operation from individual and organizations. Those who donate benefit by receiving a tax deduction for their contributions. NFP's must still pay income taxes on activities which earn revenues not tied directly to the nonprofit's primary goals and purposes.

NFPs may receive more than they spend in any given period; this excess over expenses may be recorded as Net Gain/Loss, Surplus or Reserves. It is appropriate for a nonprofit to generate some net gain so as to build a reserve account in case of emergency, short-falls, future needs or opportunities to expand services. But, if the surplus for a given year is large, then donors and funders may question the nonprofit's need for their funds and future contributions may be reduced. Generally, conservative management would encourage a planned spending schedule during the year equal to about ninety percent (90%) of the anticipated revenue stream. This allows for a current cash position able to meet unanticipated short-term

needs, while providing a reserve account for future funding needs (an endowment at a college or university is a good example of this).

When economic downturns occur, many NFPs find attracting funding a challenge causing the nonprofit to enter into financial difficulties. Endowments fall in value and generate less cash flow for use by the organization, contributions fall as people become more cautious, charitable contributions are less attractive as tax shelters due to reduced income, and government funding (grants) are often curtailed. Yet, the need for these charities' services grows as the more vulnerable who are hit by the decline in the economy are the people for whom the nonprofit was most likely designed. Whenever there is a liquidity concern, even the best of institutions need to seek solutions such as slowing down payments, cutting services, or delaying payment on employees' federal withholding taxes (though there is a penalty associated with delaying withholding taxes). The Internal Revenue Code requires employers to withhold federal income taxes, Social Security taxes, and Medicare and Federal Insurance Contributions Act (FICA) taxes from employees' wages. The Internal Revenue Service (IRS) can decide to pursue both the NFP's assets and the personal assets of individuals who are directly or indirectly associated with a nonpayment of taxes. This creates a responsibility and vulnerability for the members of the Board of Directors, of which issue and risk many are unaware.

## **DIFFICULTIES EMERGE**

As with many community-based nonprofit corporations, DEDC's primary source of funding is government contracts. From 2005 to 2008, DEDC lost government grants or contracts that aggregated over \$900,000 in value. Since 2000, the average annual revenue budget for DEDC has been about \$1.7 million; but the Executive Director explained the steady drop in funding was a result of the *Great Recession* (December 2007 to June 2009) the nation was suffering. He explained that he had every expectation that the revenues for the NFP would improve as did the economy.

Among the contracts lost by DEDC were two contracts issued by the State Division of Housing and Community Renewal ("DHCR"). The first cancellation of a contract, which was for \$55,000 designed to encourage neighborhood preservation, occurred at the end of 2004. This cancellation was due to issues unrelated to DEDC's operation but merely reflected a change in City policy. This event set a precedent that the Director used to explain as to why other contracts were cancelled. The second contract by the same agency, which was for \$425,000 to provide weather protection services to community landlords, was cancelled at the end of 2005. This cancellation was directly related to the granting agency's concern that much of their funding may have been diverted to subsidize fees associated with new fee-based services DEDC was now offering. These new services, without accompanying fund raising, had led to a funding shortfall (Net Gain/Loss) of \$180,597 that year.

At the end of 2005, DEDC also lost two city contracts worth approximately \$250,000 in the aggregate, one with the Department of Employment whereby DEDC administered a summer employment youth program and one contract with the Department of Business Services to provide technical assistance to local merchants. In their justifications for these cancellations, the granting agencies had noted their concern over the choice by DEDC to double the fees associated with these services, an action they were not willing to support. From 2006 into 2007, DEDC also lost a number of smaller City and State contracts including ones designated by local elected officials amounting to \$80,000, often for similar reasons.

Beginning in the middle of 2007, DEDC also saw a reduction in non-government funding including developer fees from housing projects and support from foundations and corporations amounting to \$175,000 annually. The \$516,237 subsidy necessary to fund the expansion into the fee-based services during 2007 cut deeply into DEDC's ability to service its more traditional operations associated with the services for which it had been formed. As a result of the shift in emphasis away from programs that addressed the Physical Deterioration and Investment Improvement of the inner city area and towards Fee Based Social Services and Special Events, the attractiveness of DEDC for traditional funding for the former programs fell such that another \$425,000 in funding was lost and not renewed during 2008. The report to the Board in late 2009 at the second meeting for the year included an additional drop in funding

of \$153,000; but the Executive Director explained that this pro forma statement would reflect improvement when the final report incorporates the actual performance for 2009. In addition, he was forecasting an upturn in the market and funding in the new year, as indicated in the projected 2010 and 2011 statements.

Pro forma statements do not necessarily need to follow GAAP (Generally Accepted Accounting Principles), but may be used by management to highlight certain important changes or aspects of the operation that will materially affect future performance. Generally, one-time events may be omitted; the financial data are determined "according to form," with estimated results based upon normal past relationships. Projected statements are another form of pro forma statements in that the data entries are estimated using *expected* ratio and/or growth assumptions, rather than historical.

It was the loss of the \$150,000 City Downtown Reinvestment Grant Program earmarked for generating improved investment opportunities, one of the oldest program services DEDC offered, that precipitated the Board's recognition of the DEDC's weakened financial condition. Late in 2009, the chairperson of DEDC's Board of Directors received a letter at her home from the City's Office of the Mayor. The letter, requesting a meeting of the Chairperson of the Board with senior City Budget Office staff, explained that the \$150,000 on-going grant would not be forthcoming for 2010. The letter indicated that the Mayor's Office was willing to discuss the non-profit's poor performance and questionable activities associated with the Reinvestment Program contract. This invitation to discuss the cancellation was due to the City's consideration of a grant for another area of DEDC's historical expertise in Economic Development. This second grant of \$124,000 would continue to support the removal of significantly deteriorated properties, following a similar grant of \$100,000 in 2008. Due to the City's commitment to the original services DEDC provided, there was strong interest in determining the long term health and management capabilities associated with this NFP. The City's budget office had serious concerns given the record of earlier cancellations, the previous use of funds granted, and the weakening support by DEDC for traditional services. This letter and the subsequent meeting caused the chairperson to call an emergency meeting of the Board of Directors to investigate the corporation's operations and financial condition.

Since the letter was sent in late 2009, the Executive Director had not yet called the semi-annual meeting of the Board for 2010. These meetings were usually held during the second quarter of the year (May) and then again six months later in the fourth quarter (November). In November 2009, the Executive Director had presented the Board with a financial review (Table 1) which included the past four years, the pro forma report for the current year (2009), and the projected reports for the next two years (2010, 2011). The Executive Director strongly argued that the impact of the recent recession had hurt their operations, but the corner had been turned in 2009, and recovery was under way both for the economy and for DEDC.

When the Board arrived at the corporation's headquarters for the emergency meeting called by the Chairperson, the executive director was not to be found. He had cleaned out his office and left a letter of resignation. Later attempts to locate him were unsuccessful. Despite the early losses of funding, the recent grants pending from the City and the current commitment of donations might allow DEDC to continue to provide services in an effort to meet the needs of the community.

As a consultant for the Board, your assistance has been requested to analyze DEDC's situation. In doing so, you have discovered a debt of over \$175,000 to the Internal Revenue Service relating to withholding tax liability and additional claims to vendors of approximately \$220,000. Your charge is to:

1. identify the missed signals the Board of Directors should have noticed by analyzing the NFP's financial records;
2. list key questions members of the Board should have asked and when; and
3. suggest ways in which the NFP may survive to still provide services to the Community.

## TEACHING NOTES

The student is asked to investigate ways in which to (a) identify the signals the Board missed so as to improve the performance of the Board of Directors who were unaware of the slide into fiscal disaster (five-year slide if measured with *Net Gain/Loss* or seven-years if measured by *Contributions*) and (b) suggest ways in which to improve the current financial situation.

This case may be used in a law course to consider the implications of bankruptcy, in a management course to identify key concerns, or in a finance/accounting course to concentrate on the financials provided. A ratio analysis, although possible, is not required for the student to make key observations from the financial statements provided.

The mission of the DEDC is to develop and coordinate programs to address physical deterioration and improve investment in the Downtown Area of a major city. DEDC has a thirty-four (34) year history of upgrading the housing stock, revitalizing commercial activity and creating jobs. During this time DEDC expanded into providing education and support services for community residents, and most recently many fee-based activities oriented towards the youth of the community.

The instructor may find that a discussion of “concentrating on core business” as a management concept is appropriate, as is, in addition, an explanation of the benefits of *focus* as a finance concept. Students should address the advisability and feasibility of continuing each of the five major programs offered, especially the newer expansion into social services and fee-based activities: Youth Programs, Immigration Assistance Programs, and Social Services Program (newest introduced). This discussion should consider the needs of the Downtown Community, the availability of funds and the emphasis on their role in supporting economic development and housing reinvestment.

With the exception of the first grant cancellation, the cutbacks were the result of state and city government agencies cutting funding for DEDC as a result of the Executive Director's mismanagement of the program; i.e. use of funds designated for one purpose diverted to another purpose. Students could discuss how the State identified the mismanagement and what the State might identify as mismanagement. As mentioned in the case, “The Executive Director used Income Statements (Table 2) and the Balance Sheet (Table 3) filed with State Agencies and the IRS to produce Summary Statement of Financial Condition (Table 1) for the Board. As such, the State had better and more information than the Board.

Students should be asked to develop various options concerning future actions by the Board to salvage or resolve the NFP's situation. Several issues may be raised, such as characteristics of the new executive director to be hired, new fiscal controls that should be introduced, cost items to be controlled and how to do so, Board staffing changes to pursue, and changes to programs that should be considered. Finance and accounting students could be asked to develop new pro forma financial statements based on their recommendations. This discussion could be extended to include the NFP's option to file a petition for bankruptcy under Chapter 11 of the Bankruptcy Code.

The most general purpose of this case is to allow the students to identify signals as red flags that the Board should have identified. A discussion centered on the ethics of and procedures chosen by the Executive Director during the decline would reveal certain definite observations concerning the financial report the Director provided the Board. Here are several remarks that the students should be encouraged to discuss.

1. The Director chose a shorter period (five years including 2009) for his Report to the Board (Table 1) since this period reflects his tenure as Director. But, students should note that the financials are available for nine years including 2009 (Tables 2 & 3); the trend may be much more apparent using the longer period.
2. The Director used the 2007 recession as a cover for the serious decline in funding, thus reducing the impact of his mismanagement: as seen in the Report, the revenues “dipped” during the Great Recession.

<b>Year</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>Total Revenue</b>	840,590	622,505	551,149	955,944	1,603,139

As seen in Table 2, a significant decline occurred from 2005 to 2006, with a drop of 40.37% in Revenues, and a drop of 42.35% in 2006 to 2007. In fact, the Revenues are seen as growing during the Great Recession which began in the last Quarter of 2007.

3. The Director chose to use deferred taxes as a means of increasing revenues, seen in the financials (listed as *Tax Liability Delayed*, see Table 2), but not in the Report (listed as *Other*, see Table 1).
4. The Director decided to provide Revenue numbers, but neither Expense or Liability numbers nor Net figures; very misleading, unless one knows to ask about the expenses and net position. This should be discussed with and by the students.

Several general observations by the students should be encouraged. Students should note that the Board was not receiving true financials, but only a summary from the Executive Director, and should not have been satisfied with just the Report they were provided. In addition, any explanation of the performance being associated with a downturn in the entire or local economy should be contrasted with the timing of the cancellation of contracts. The City and State had begun cancelling contracts in the 2001 to 2004 period, before the Great Recession. This may have caused members of the Board to raise questions as to why this was happening, and perhaps leading to the discovery of the mismanagement that had led to dissatisfaction by grantor of funds as to the services received or generated by DEDC. This discussion could be expanded to include or shifted to the composition of the Board, requirements for their training and participation, and/or the selection process for a Board.

Students should express concerns considering (1) the relationship between either core or expanded services and the costs or revenues associated with each; (2) The increase in costs without the necessary increase in revenues (or funding); (3) The cumulative loss of grants that caused the funding to fall from a high of \$1.47 million (2001) to a low of \$280 thousand (2007); and (4) the significant increase in expenses for *Fee Based Social Services* and *Special Events*, without receiving offsetting revenues or grant funding. Looking at just 2004 to 2005, expenses associated with *Fee Based Social Services* (recently expanded) ballooned to \$600-700 thousand with only \$100-200 thousand in revenues, causing a need for funding at about a half-million dollars. Although much smaller in dollar amount, *Special Events* (recently introduced in 2004) in 2005 to 2006 increased costs by \$50-70 thousand while producing roughly \$20 thousand in revenues, adding to the shortfall. Students may be encouraged to note that had DEDC not expanded its operations into Special Events and, especially, Fee Based Social Services, the net revenues in 2006 would have been positive at \$14,933, rather than negative at (\$100,791). A discussion and exercise could be pursued wherein the students are encouraged to see the cumulative change had DEDC not expanded into its recent activities.

Other observations that the students should be encouraged to note and/or discuss are (1) the recent increase in short term financing and the difficulties associated with an increasing dependence on such, even with historically low rates; and (2) the impact of the sale of the home office building. Sales of fixed assets are often used as a means to carry firms through difficult times, as with the Airline industry in the mid-1970s to 1980s in the midst of the oil crisis, rising fuel costs, and increased fear of terrorism which led to a decline in ridership. Students could be introduced to the concept of a sale-lease-back arrangement.

If a ratio analysis is considered, then the key concept to introduce to the students would be a trend analysis using both the five years in the Report to the Board and the nine years in the financial statements. Finally, students should be encouraged to walk away from this case with the recognition of the significance of Board oversight, the need to ask questions, and the importance of remaining focused concentration on core operations.

## APPENDIX 1

### Structure of Not-for-Profit Corporations

New York's Not-for-Profit Corporations (NFP) are created and governed pursuant to the state's Not-for-Profit Corporation Law (N-PCL). In order to qualify as a Not-for-Profit corporation under the N-PCL, the corporation must be formed primarily to serve a non-pecuniary purpose [N-PCL § 204]. No part of the

assets, income or profit of the organization may be distributed or inure to the benefit of the organization's members, directors or officers except in limited circumstances, such as compensation or salary for services rendered [N-PCL §§ 204 & 508]. NFPs cannot issue stock and, therefore, are not "owned" by anyone. Rather, NFP's assets are considered to be owned by the public. Structured as either membership or non-membership corporations [N-PCL § 601a], the NFP has no shareholders; it is controlled either by its members or its Board of Directors depending on its corporate structure. The members or the Board may only act in furtherance of the corporation's charitable purposes.

Not-for-Profits raise capital with subventions and capital contributions, which are akin to debt. Capital contributions can be made either at the time of a member's admission to a Not-for-Profit, or thereafter. In mergers and acquisitions, capital contributions are non-transferable (except in certain circumstances by Type A corporations). Also, they have no bearing or relation to the control of the corporation. Subventions are not debt of the corporation, although redeemable at the option of the corporation upon the occurrence of the conditions provided for in the resolution authorizing the subvention. However, subvention holders may be entitled to interest. The amount of interest is limited to two-thirds of the maximum rate authorized in the General Obligations Law. Unlike capital contributions, subvention certificates are transferable and can be held by non-members and members alike, although they cannot confer control of a corporation [N-PCL §§ 501, 504 & 505].

There are four different types of Not-for-Profit Corporations in New York State. *Type A* may be formed for any lawful non-business purpose, including, but not limited to civic, social, patriotic, political, athletic and for a professional, commercial, industrial, trade or service association. *Type B* may be formed for one or more non-business purposes, including charitable, educational, religious, scientific, literary, cultural purposes, or prevention of cruelty to children or animals. *Type C* may be formed for any lawful business purpose to achieve a lawful public or quasi-public objective. Finally, *Type D* corporations may be formed when authorized by any other New York corporate law for any business or non-business, pecuniary or non-pecuniary purpose.<sup>1</sup>

In a membership NFP, the members have the power to control and influence the organization in that they elect the Board, and by statute must authorize certain corporate actions such as dissolution, merger, and the sale of all or substantially all of the assets of the corporation [N-PCL § 613]. Members control a Not-for-Profit corporation in much the same way that shareholders control business corporations. Individuals, corporations, joint stock associations, unincorporated associations and partnerships may all be members of Not-for-Profit corporations. On the other hand, a non-membership Not-for-Profit Corporation is controlled by its Board of Directors [N-PCL § 701a]. The Board serves as the governing body and determines the general policies of the corporation and oversees its operations.<sup>2</sup> All significant corporate actions, such as dissolution, merger, consolidation or sale of all or substantially all of the corporation's assets, must be approved by the board.<sup>3</sup> Vacancies on the board are filled by the vote of existing board members [N-PCL § 705a]. Regardless of whether a corporation is structured as a membership or non-membership corporation, its directors are charged with satisfying their fiduciary obligations: the duty of care; the duty of loyalty; and the duty of obedience.<sup>4</sup>

The duty of care requires that directors and officers be attentive to the organization's finances and activities and actively oversee the way in which its assets are managed.<sup>5</sup> Essentially, directors are required to act with common sense and informed judgment. Diligence and due care requires affirmative conduct on the part of the board of directors. It implies an active interest in the organization's activities. This includes paying attention to potential problems affecting the organization [Bjorklund, Fishman & Kurtz, 1997]. The duty of loyalty requires board members to pursue the interests and mission of the not-for-profit organization with undivided allegiance. This includes not placing private interests above the charity's interests. The members of the board of directors must "subordinate their individual and private interests to their duty to the corporation."<sup>6</sup> The duty of obedience includes the obligation of board members to act within the organization's purposes and ensure that the corporation's mission is pursued.<sup>7</sup>



## APPENDIX 2

### Epilogue

The Board of the Not-for-Profit company in question followed several paths to restore fiscal viability. First, it hired an executive director with an extensive background in finance and connections within the not-for-profit community. Second, the Board implemented new fiscal controls so as to receive more frequent financial as well as operational reports, brought its operational costs in line with its current budget, reduced its overhead expenses, and implemented substantial corporate employee changes. Third, at the onset of the restructuring, several long-term employees were laid-off since their salaries were not reimbursable under existing contracts. Specifically, the full-time fiscal director, director of administration and office assistant were laid-off. Fourth, in addition to the staffing changes, several new board members, all of whom work in the nonprofit sector, have joined the Board of Directors.

In an effort to reduce costs, DEDC sold the building that housed its headquarters and used the proceeds to reduce its debt to the Internal Revenue Service. Following the sale, DEDC relocated and leased a more affordable office space. Prior to the sale of the building the IRS had imposed a lien on the NFP and assessed tax penalties against it. The creation of this lien and the levy on the lien triggered the government's refusal to certify DEDC contracts and reimburse it for funds it had already committed to the ongoing projects. Upon DEDC's payment, the IRS lifted the levy and allowed the reimbursement of funds from existing contracts to flow. In addition, this payment was necessary to negotiate the abatement of tax penalties and to build the DEDC's credibility among other funding sources.

DEDC's Board and management re-evaluated its goals for the programs it offered and made the strategic decision not to seek increased funding or to expand beyond its traditional service areas. Instead, DEDC decided to concentrate its efforts on strengthening its existing programs around a core of economic development programming. This decision is based on two factors; (1) the needs of the Downtown Community; and (2) a willingness of fund providers to support community economic development activity. While DEDC was committed to continuing activities in each of its five program areas, the programs were adjusted to emphasize the role they play in supporting economic development.

Despite these efforts, DEDC's Board of Directors recognized that a more drastic remedy was needed because it lacked the unrestricted assets necessary to pay its remaining debt. It was in an effort to ensure DEDC's long-term viability that the Board of Directors opted to file a petition for bankruptcy under Chapter 11 of the Bankruptcy Code after two years of trying to strengthen its situation after the reorganization.

### ENDNOTES

1. See N-PCL § 201(b) and LAWYERS ALLIANCE FOR NEW YORK, GETTING ORGANIZED Chapter 3 (Allen R. Bromberger et al. eds, 5th ed. 1999).
2. Board Basics: A Primer for Community Development Organizations; The Enterprise Foundation, pg. 5.
3. N-PCL §§ 510(a)(1); 903(a); 1002(a); 1102(a)(i).
4. See generally; N-PCL Article 7.
5. N-PCL §701(a) and §717: "Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent [persons] would exercise under similar circumstances in like positions."
6. Nechis v. Gramatan, (1962)).
7. "Unlike business corporations, whose whole ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetration of particular activities are central to the raison d'être of the organization." Bjorklund et al., supra, p. 414.

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**TABLE 1**  
**SUMMARY STATEMENT OF FINANCIAL CONDITION**

**Annual Summary Report from the Executive Director to the Board of Directors**

<b>Year</b>	<b>Projected 2011</b>	<b>Projected 2010</b>	<b>Pro Forma 2009</b>	<b>Actual 2008</b>	<b>Actual 2007</b>	<b>Actual 2006</b>	<b>Actual 2005</b>
Contributions	942,715	670,500	379,750	535,712	1,011,763	1,341,763	1,593,370
Program Services	385,486	303,595	245,590	345,300	479,600	308,230	120,194
Investments	3,900	1,200	500	0	0	0	0
Special Events	21,842	12,320	11,453	10,242	9,987	7,566	0
Other	2,647	25,890	34,356	54,690	45,789	42,498	1,949
<b>Total Revenue</b>	<b>1,356,590</b>	<b>1,013,505</b>	<b>671,649</b>	<b>945,944</b>	<b>1,547,139</b>	<b>1,700,057</b>	<b>1,715,513</b>
<b>Year</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>ASSETS</b>							
Cash & Equivalents	30,189	28,415	3,450	1,875	4,970	54,508	72,355
Accounts Receivable	12,732	14,363	212,325	292,450	212,530	127,098	50,565
Pledges & Grants Receivable	195,370	159,316	114,322	153,090	108,461	87,787	276,500
Receivables/Other	0	0	88,264	74,574	64,545	48,950	0
Prepaid Expenses	3,200	900	0	0	519	1,404	8,200
Inventories for Sale or Use	0	0	0	0	0	0	0
Fixed Assets	75,000	75,000	75,000	75,000	75,000	75,000	75,000
<b>TOTAL ASSETS</b>	<b>286,491</b>	<b>277,994</b>	<b>275,360</b>	<b>236,415</b>	<b>251,372</b>	<b>255,833</b>	<b>482,620</b>
<b>LIABILITIES</b>							
Accounts Payable	496,199	593,488	640,141	537,875	480,892	394,754	352,769
S-T Loans and Notes	32,000	25,000	1,800	1,700	2,800	2,500	10,000
Other	95,515	117,121	225,450	215,675	185,724	96,026	105,000
<b>TOTAL LIABILITIES</b>	<b>623,714</b>	<b>735,609</b>	<b>867,391</b>	<b>755,250</b>	<b>669,416</b>	<b>493,280</b>	<b>467,769</b>

**TABLE 2**  
**DOWNTOWN ECONOMIC DEVELOPMENT CORPORATION**  
**STATEMENT of REVENUES and EXPENSES**

<i>Year</i>	<i>2009</i>	<i>2008</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
<b>REVENUE</b>					
Contributions	796,715.00	549,500.00	379,750.00	535,712.00	1,011,763.00
Direct Public Support	292,715.00	169,500.00	99,750.00	102,354.00	153,405.00
Government Grants	504,000.00	380,000.00	280,000.00	433,358.00	858,358.00
Program Services	35,486.00	53,595.00	125,590.00	345,300.00	525,600.00
Physical Deterioration	20,000.00	26,000.00	50,000.00	75,000.00	203,450.00
Investment Improvement	14,236.00	25,460.00	29,915.00	47,950.00	143,500.00
Fee Based Social Services	1250	2135	45675	222350	178650
Investments					
Interest, dividends etc.	3,900.00	1,200.00	0.00	0.00	0.00
Special Events					
Trips, Camp, Socials	1,842.00	2,320.00	11,453.00	20,242.00	19,987.00
Other					
Tax Liability delayed	2,647.00	15,890.00	34,356.00	54,690.00	45,789.00
<b>Total Revenue</b>	<b>840,590.00</b>	<b>622,505.00</b>	<b>551,149.00</b>	<b>955,944.00</b>	<b>1,603,139.00</b>
<b>EXPENSES</b>					
Program Services	659,610.00	475,610.00	406,110.00	823,201.00	1,581,337.00
Physical Deterioration	400,000.00	320,000.00	200,000.00	400,000.00	500,000.00
Investment Improvement	252,450.00	128,450.00	98,950.00	135,750.00	386,450.00
Fee Based Social Services	7,160.00	27,160.00	107,160.00	287,560.00	694,887.00
Administration	19196	48520	152310	143350	134610
Fundraising	34,550.00	28,203.00	15,169.00	19,428.00	21,033.00
Special Events					
Trips, Summer Camp, Socials	6,842.00	10,756.00	50,756.00	70,756.00	46,756.00
Total Expenditures	720,198.00	563,089.00	624,345.00	1,056,735.00	1,783,736.00
NET GAIN / LOSS	120,392.00	59,416.00	-73,196.00	-100,791.00	-180,597.00
BOY net assets/fund balances	-532,615.00	-592,031.00	-518,835.00	-418,044.00	-237,447.00
EOY net assets/fund balances	-412,223.00	-532,615.00	-592,031.00	-518,835.00	-418,044.00

**TABLE 2 (continued)**  
**DOWNTOWN ECONOMIC DEVELOPMENT CORPORATION**  
**STATEMENT of REVENUES and EXPENSES**

<i>Year</i>	<i>2004</i>	<i>2003</i>	<i>2002</i>	<i>2001</i>
<b>REVENUE</b>				
Contributions	1,341,763.00	1,593,370.00	1,644,754.00	1,683,613.00
Direct Public Support	228,405.00	229,870.00	226,304.00	216,713.00
Government Grants	1,113,358.00	1,363,500.00	1,418,450.00	1,466,900.00
Program Services	308,230.00	120,194.00	76,356.00	39,877.00
Physical Deterioration	142,340.00	68,400.00	50,010.00	20,000.00
Investment Improvement	63,545.00	34,294.00	19,321.00	13,127.00
Fee Based Social Services	102345	17500	1925	1750
Investments				
Interest, dividends etc.	0.00	0.00	5,239.00	5,290.00
Special Events				
Trips, Camp, Socials	17,566.00	0.00	0.00	0.00
Other				
Tax Liability delayed.	42,498.00	1,949.00	1,367.00	1,536.00
<b>Total Revenue</b>	<b>1,710,057.00</b>	<b>1,715,513.00</b>	<b>1,727,716.00</b>	<b>1,730,316.00</b>
<b>EXPENSES</b>				
Program Services	1,773,193.00	1,615,253.00	1,555,943.00	1,547,443.00
Physical Deterioration	700,000.00	800,000.00	800,000.00	800,000.00
Investment Improvement	475,575.00	596,635.00	616,335.00	596,835.00
Fee Based Social Services	597,618.00	218,618.00	139,608.00	150,608.00
Administration	128356	113356	109283	104356
Fundraising	32,050.00	42,050.00	41,030.00	40,350.00
Special Events				
Trips, Summer Camp, Socials	28,756.00	0.00	0.00	0.00
Total Expenditures	1,962,355.00	1,770,659.00	1,706,256.00	1,692,149.00
NET GAIN / LOSS	-252,298.00	-55,146.00	21,460.00	38,167.00
BOY net assets/fund balances	14,851.00	69,997.00	48,537.00	10,370.00
EOY net assets/fund balances	-237,447.00	14,851.00	69,997.00	48,537.00

**TABLE 3**  
**DOWNTOWN ECONOMIC DEVELOPMENT CORPORATION**  
**BALANCE SHEET**

Year	2009	2008	2007	2006	2005
<b>ASSETS</b>					
Cash & Equivalents	30,189.00	28,415.00	3,450.00	5,875.00	4,970.00
Accounts Receivable	12,732.00	14,363.00	122,325.00	102,450.00	92,530.00
Pledges & Grants Receivable	165,370.00	159,316.00	74,585.00	53,090.00	78,153.00
Receivables/Other	0.00	0.00	0.00	0.00	0.00
Prepaid Expenses	3,200.00	900.00	0.00	0.00	719.00
Inventories for Sale or Use	0.00	0.00	0.00	0.00	0.00
Fixed Assets	75,000.00	75,000.00	75,000.00	75,000.00	75,000.00
<b>TOTAL ASSETS</b>	<b>286,491.00</b>	<b>277,994.00</b>	<b>275,360.00</b>	<b>236,415.00</b>	<b>251,372.00</b>
<b>LIABILITIES</b>					
Accounts Payable	496,199.00	593,488.00	640,141.00	537,875.00	480,892.00
S-T Loans and Notes	32,000.00	25,000.00	1,800.00	1,700.00	2,800.00
Other	95,515.00	117,121.00	225,450.00	215,675.00	185,724.00
<b>TOTAL LIABILITIES</b>	<b>623,714.00</b>	<b>735,609.00</b>	<b>867,391.00</b>	<b>755,250.00</b>	<b>669,416.00</b>
<b>FUND BALANCE</b>	<b>-337,223.00</b>	<b>-457,615.00</b>	<b>-592,031.00</b>	<b>-518,835.00</b>	<b>-418,044.00</b>
Year	2004	2003	2002	2001	
<b>ASSETS</b>					
Cash & Equivalents	4,544.00	72,355.00	105,822.00	91,666.00	
Accounts Receivable	87,098.00	50,565.00	14,675.00	22,750.00	
Pledges & Grants Receivable	87,787.00	276,500.00	386,750.00	332,500.00	
Receivables/Other	0.00	0.00	0.00	0.00	
Prepaid Expenses	1,404.00	8,200.00	14,356.00	12,304.00	
Inventories for Sale or Use	0.00	0.00	0.00	0.00	
Fixed Assets	75,000.00	75,000.00	75,000.00	75,000.00	
<b>TOTAL ASSETS</b>	<b>255,833.00</b>	<b>482,620.00</b>	<b>596,603.00</b>	<b>534,220.00</b>	
<b>LIABILITIES</b>					
Accounts Payable	394,754.00	352,769.00	338,606.00	345,683.00	
S-T Loans and Notes	2,500.00	10,000.00	13,000.00	15,000.00	
Other	96,026.00	105,000.00	175,000.00	125,000.00	
<b>TOTAL LIABILITIES</b>	<b>493,280.00</b>	<b>467,769.00</b>	<b>526,606.00</b>	<b>485,683.00</b>	
<b>FUND BALANCE</b>	<b>-237,447.00</b>	<b>14,851.00</b>	<b>69,997.00</b>	<b>48,537.00</b>	

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