AHLA PG Briefing

Don't Let the Headlines Hide the Lessons for Your Boards, Part 2

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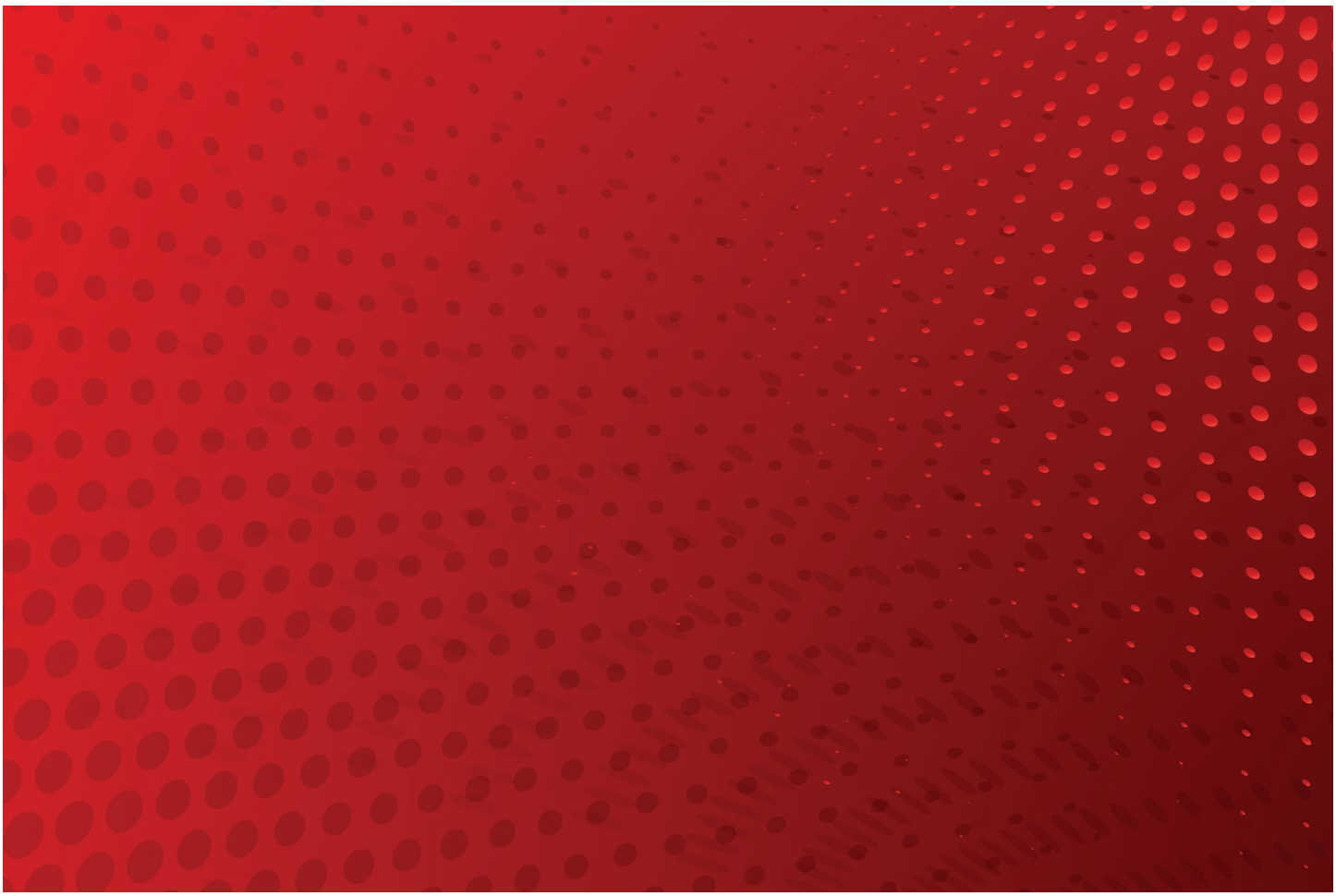

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Attorneys advising nonprofit boards should continue to monitor the New York State Attorney General's case against the Trump Foundation and the Trump family members for important guidance. Specifically, on November 23, 2018, New York State Supreme Court Justice Saliann Scarpulla denied a motion to dismiss the lawsuit brought by the Attorney General of the State of New York, Barbara Underwood (Petitioner),[1] against the Donald J. Trump Foundation (Foundation) and its officers and directors, Donald J. Trump, Donald J. Trump, Jr., Ivanka Trump, and Eric Trump (collectively, Respondents).[2]

Review of Trump Foundation Complaint

As discussed in the AHLA Business Law and Governance Practice Group's July 18, 2018 Alert "Don't Let the Headlines Hide the Lessons for Your Boards,"[3] the Attorney General's complaint was grounded in allegations of breach of fiduciary duty, violation of statutory requirements and related party transaction requirements, and waste, as it focused on alleged failures of the Respondents to fulfill their fundamental fiduciary obligations as directors to a tax-exempt not-for-profit corporation.[4]

Although Justice Scarpulla's analysis specifically addressed requirements under New York's Not-For Profit Corporation Law and its Estates, Powers and Trusts Law, her opinion (which rejected the motion by the Foundation and the Respondents to dismiss the underlying complaint), as well as the underlying complaint, both serve as important educational resources for all nonprofit boards.

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[1] 451130/2018 People of the State of New York, by Barbara D. Underwood, Attorney General of the State of New York, Petitioner, v. President Trump, Donald Trump, Ivanka Trump, Eric Trump, and The Donald J. Trump Foundation, Respondents, Motion No. 002 (10-25-2018)001.
[2] 451130/2018 People of the State of New York, by Barbara D. Underwood, Attorney General of the State of New York, Petitioner, v. President Trump, Donald Trump, Ivanka Trump, Eric Trump, and The Donald J. Trump Foundation, Respondents, Motion No. 002 (11-23-2018)002.
[3] *See* https://www.healthlawyers.org/Members/PracticeGroups/PGCSAlerts/Pages/BLG/Dont_Let_the_Headlines_Hide_the_Lessons_for_Your_Boards.aspx.
[4] New York refers to incorporated charitable organizations as "not-for-profit corporations." Most other states refer to them as "nonprofit corporations." For purposes of this article, they will be referred to as "nonprofit corporations."

To understand the decision, it is important to recognize that the allegations in the underlying complaint asserted, among other things, that the board of directors for the Foundation, over the 19 years of its existence:

- Did not hold a meeting or establish any essential corporate formalities;
- Failed to oversee the activities, including the financial management of the Foundation and the approval of distributions of corporate assets by the Foundation;
- Ceded to management and to individuals and other organizations who were not associated with the Foundation oversight and use of its charitable assets; and
- Failed to manage conflicts of interest by allowing the misuse of charitable assets for the personal benefit of a board member.

As a result of these purported failures, the New York Attorney General sought monetary damages and dissolution of the Foundation. In addition, the suit seeks to bar the Respondents from future services on nonprofit boards during a specific period of time.

Holdings on the Motion to Dismiss

The Foundation's attorneys did not dispute the underlying claims, but instead moved to dismiss the complaint by deploying various defenses, including statutes of limitations, assertions that the Foundation's activities related to a January 26, 2016 political fundraiser[5] (Fundraiser) did not yield a Related Party Transaction or corporate waste or constitute prohibited political activity, and that the Attorney General's office had a pervasive bias against the President, as well as claims of presidential bar. The court

[5] Brianne Pfammemstiel, *Trump on rally: Isn't this better than the debate?*, DES MOINES REGISTER, Jan. 28, 2016, https://www.desmoinesregister.com/story/news/elections/presidential/caucus/2016/01/29/trump-rally-isnt-better-than-debate/79462842/; Brianne Pfammemstiel, *Des Moines fundraiser at center of New York lawsuit against Donald Trump, his foundation*, DES MOINES REGISTER, June 14, 2018, https://www.desmoinesregister.com/story/news/2018/06/14/donald-trump-foundation-iowa-caucus-illegal-conduct-lawsuit/701564002/.

rejected all the defenses, and in doing so sent some important messages to nonprofit boards and their board members regarding their fiduciary duties.

- ***Continuing Wrong Doctrine May Apply in Governance Situations.*** The Respondents argued that some of the transactions cited in the complaint dated to 2007 and 2012 and so were time-barred under applicable statutes of limitations. The court disagreed, applying the continuing wrong doctrine (which health care lawyers frequently see discussed in malpractice cases) that statutes of limitations on a breach of fiduciary duty claim do not start to run until the fiduciary relationship is repudiated or otherwise terminated. The court held that "Petitioner's allegations set forth a continuing wrong, i.e. Respondents' alleged continuous and pervasive failure to operate and manage the Foundation [over 19 years] in accordance with corporate and statutory rules and fiduciary obligations, resulting in the misuse of charitable assets and self-dealing . . . ." The holding emphasizes the need for boards to actively maintain their corporate formalities, and for individual board members to fulfill their fiduciary obligations, as an ongoing pattern of uncorrected failures to do so could result in liability for actions that otherwise would be outside the statute of limitations. Corporate formalities may seem on occasion like a purposeless exercise, but their abandonment is perceived to reflect the abandonment of other corporate responsibilities to the detriment of the organization and the director.

- ***Related Party Transactions Are Not Limited to Financial Deals.*** The complaint alleged that certain conduct connected to the Fundraiser for President Trump's campaign for President (Campaign) constituted a "related party transaction" (RPT) and that it had been inappropriately handled by the board. The Foundation responded that the conduct did not constitute an RPT because it was not a financial business transaction between a Respondent (and/or his organization) and the Foundation. In dismissing this defense, the court emphasized the relevant statutory language that defined an RPT as any "transaction, agreement or *any other arrangement*" (emphasis added). Justice Scarpulla read the emphasized language broadly when she ruled that the

arrangement need not constitute a financial deal. Specifically, the court ruled a third party, namely the Campaign, had "exploited . . . control of Foundation assets by dictating when and to which charities the Foundation distributed funds it received . . . to advance the" personal interest (i.e., the presidential bid) of a board member. In sum, the court held that by allowing a third party to direct a nonprofit's disbursements, or by allowing the nonprofits funds to be used to benefit a personal interest of a director (even if the interest is not itself a financial interest), directors and officers may be abdicating and breaching their fiduciary duties to the organization.

- ***Ignorance of the Law Remains No Defense.*** With respect to the RPT claims, the Attorney General sought double damages based on an allegation that the associated actions were willful and intentional. The Foundation's attorneys asserted that the board member did not *in fact* know his conduct was prohibited as an RPT. The court held that the drawing up of checks at the direction of the board member and the Campaign and the board member's signing and presenting the checks at the Fundraiser constituted willful and intentional action under the statute even if he did not realize that the action was illegal. The takeaway here is that health care and nonprofit attorneys must always remind clients that ignorance of the law remains no defense.

- ***Waste May Occur Even with a Charitable Donation.*** The Foundation's attorneys asserted that the causes of action in the complaint relied on a claim of waste that they asserted could occur "only when a charity's assets are used for non-charitable purposes" and that because "the Foundation's funds were eventually disbursed to charities there was no waste. . . ." While acknowledging that the Foundation's funds "ultimately ended up in [the hands of] charitable organizations" and certain moneys had been reimbursed, the court rejected the Foundation's argument. Instead, the court held that "'the essence of a waste claim is 'the diversion of corporate assets for improper or unnecessary purposes.' . . . Under this definition of waste, the inquiry does not end simply because the ultimate beneficiary of the assets was a charity. Instead, waste may still be found

when assets were utilized improperly or unnecessarily in breach of fiduciary duty, even if the ultimate beneficiary of the assets was a charity." The Fundraiser raised issues not because the funds went to a non-charitable purpose (they did not). It was because the funds were directed to be disbursed by a third party (i.e., the Campaign) that had no legal relation to the Foundation, and that the funds were used to benefit a director's personal political interest, according to the court. From the court's perspective, the crux of the issue of waste is the behavior of the individual directors and the board as a whole and is not merely an inquiry into where the funds ultimately ended up. This emphasizes the importance of an organization understanding that a conflict of interest may not be financial, staying on top of potential conflicts of interest, and formally addressing them when they arise.

- ***Retrospective Corrective Action Is Not Enough.*** That the funds ended up in charitable hands did not end the inquiry by the Attorney General and the court. The court found that the issuance of the grants initially was tainted by conflicts of interest and was problematic. Moreover, the court held that "voluntary cessation of allegedly illegal conduct does not deprive the tribunal of power to hear and determine the case." It is not enough for a board to go back and fix something once regulators identify it as a problem. To fulfill its fiduciary duty to the organization, the board needs to ensure that the problem will not arise again, and if the problem was great enough in the first place a case may still be brought against an organization and/or its board members for their failures to fulfill their obligations to their nonprofit organizations, according to the court. Directors need to be aware that under this reasoning it isn't enough that a breach occurred years previously if the director stayed on the board that did not rectify earlier the inappropriate action and/or the processes that enabled it. Both need to be corrected for a director to fulfill his or her duty to the organization.

- ***Remember the Certificate of Incorporation and the Internal Revenue Code.*** The Attorney General's complaint also argued that the Foundation, through its activities associated with the Fundraiser for the Campaign, engaged in political

activity prohibited by its own certificate of incorporation and by Section 501(c)(3) of the Internal Revenue Code (IRC). The Foundation argued that the directors were functioning in their individual capacities at the Fundraiser. The court, citing IRS Revenue Ruling 2007-41, held that "[a]lthough an organization's leaders may attend political functions in their individual capacity, 'for their organization to remain tax exempt under section 501(c)(3), leaders cannot make partisan comments in official organization publications or at official functions of the organization.'" The Attorney General alleged that in light of the allegations of coordination between the Campaign and the Foundation, and the control that the Campaign asserted over the Foundation's disbursements, the President was acting in a dual capacity as a candidate *and* as president of the Foundation during the Fundraiser, and thus the Foundation had crossed the line into prohibited political activity. It is also worth remembering that to the extent that the activity violated the Foundation's certificate of incorporation it may also be considered *ultra-vires*. The case is a reminder about the importance of separating the political expressions of individual board members from the organization's own sponsored statements and activities.

- ***Just Because the Regulator May Be Biased Doesn't Mean She Can't Bring the Case.*** The Foundation's attorneys claimed that the case should be dismissed because it was only brought out of bias, specifically political bias against the President and his family members. Although potential bias of the type presented by this case may be rare, organizations and directors may frequently believe (occasionally with justification) that a regulator is biased against them and so seek to have a claim rejected. The court found no basis to assert that bias and animus against the Respondents were "the sole motivating factors for initiating the investigation and pursuing this proceeding." Moreover, the court ruled that a potential animus did not constitute grounds to dismiss the claims. "It is not within the province of courts to subjectively determine the motivation of a government agency in commencing an enforcement proceeding, ... Instead, it is [the court's] responsibility to review the petition to see if it has legal and factual support . . . ." Accordingly, a hospital or a health-related foundation facing a

citation or suit by a regulator may find itself up against a regulator who lost a family member (or otherwise had a bad experience) at one of its facilities. As a result, it may feel that the citation or suit are inappropriate due to the perceived bias. This does not matter. Under the court's decision, bias, of any kind, is not relevant if the regulator genuinely identifies one or more problems that are otherwise subject to regulatory or legal enforcement.

Epilogue[6]

Following the ruling, the parties (after a long period of negotiation) entered into a stipulation whereby the Foundation agreed to dissolve, which it did on December 19,

[6] Some of the most newsworthy issues raised by the case are jurisdictional and unique to its status as a suit against a sitting president of the United States. As such they are unlikely to impact board members' understanding of their fiduciary responsibilities. Nonetheless, they are interesting and for those who are curious:

(a) The Foundation's attorneys asserted that as a sitting president President Trump may not be sued. Citing *Clinton v. Jones*, the court held that the doctrine of separation of powers does not bar state law claims against the President who is "'is subject to [both federal and state] laws' for unofficial acts". Accordingly, his identity as President does not provide him with immunity from suit. Moreover, their assertion that that "federal courts are better able to manage cases against a sitting president to avoid interfering with official duties" was "meritless," according to Justice Scarpulla. State courts, she held, were capable of giving the appropriate deference to presidential responsibilities and accommodating Mr. Trump's needs to govern. "A state court action does not impose any greater burden on a sitting president than a federal court action."

(b) The Foundation's attorneys also argued that state courts were prohibited from interfering with the federal responsibilities of a federal officer (like the President) by exercising control over the officer. Again, citing *Clinton v. Jones*, the court held that "the allegations raised in the [complaint] do not involve any action taken by Mr. Trump as president and any potential remedy [sought by the Attorney General] would not affect Mr. Trump's official federal duties."

(c) The Foundation's attorneys argued that federal courts were "better suited to address legal issues that arise in cases against federal officials." In support, they relied upon a proposition from Supreme Court dissenting opinion that "federal courts have greater expertise than state courts in applying federal law." In rejecting this argument, Justice Scarpulla held that "resolution of the petition is governed entirely by New York law; thus, a federal court's alleged superior knowledge of federal law is inapposite."

In rejecting the jurisdictional arguments asserted by counsel to the Foundation and to the President, Justice Scarpulla relied upon the holdings of *Clinton v. Jones* (520 U.S. 681 (1997), as well as the less familiar *Zervos v. Trump* (59 Misc.3d 790 (Sup. Ct. N.Y. Co. 2018)), which (in a defamation suit against President Trump) held "there is . . . no authority for dismissing . . . a civil action related purely to unofficial conduct because [the] defendant is the President of the United States." The holding by New York State Supreme Court Justice Jennifer Schecter in *Zervos* was upheld in a slip opinion issued by the Appellate Division of the State of New York, First Department, on March 14, 2019. *Zervos v. Trump,* 2019 NY Slip Op 01851, Decided on March 14, 2019, Appellate Division, First Department.

2018. The Foundation also agreed to give away all its remaining assets under court supervision. The stipulation did not result, however, in a settlement of the case and it appears that the Attorney General plans to continue her pursuit of the Foundation's officers and directors on the allegations set forth in the complaint.

The most important lesson to be learned is fundamental to all boards—fiduciary obligation is paramount to good governance. As counsel for health care and nonprofit corporations, it is important to educate board directors with adequate orientation and annual training to assure they fully understand their role and appreciate the potential implications of failing to discharge their fiduciary duties.

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