

“When Good Gifts Go Bad,” Nancy A. Baker, Alzheimer’s Association, Mountain View, California, and Erik Dryburgh, Adler & Colvin. Reprinted with permission from *The Journal of Gift Planning*, Volume 10/Number 1, First Quarter 2006.

## **WHEN GOOD GIFTS GO BAD**

Nancy A. Baker and Erik Dryburgh

In the world of charitable gifts, it’s rarely—if ever—possible to follow the old adage “Never look a gift horse in the mouth.” A number of charitable organizations were reminded of that fact last year when what looked like an outright major gift became something else all together. This particular situation may never happen to you. In fact, we HOPE it never does. But the lessons to be learned from it apply to almost every prospective major and planned gift.

### **THE GIFT**

In mid May 2004, the donor, Mr. Jones (not his real name), sent a letter to the Alzheimer’s Association (the Association) stating his intent to make a gift of securities and requesting that the Association provide its taxpayer identification number and any instructions necessary to accomplish the transfer. The letter found its way to Nancy in the planned gifts department, and she graciously replied to Mr. Jones and provided transfer information. Two weeks later, he sent a second letter informing the Association that he was instructing two mutual fund companies to transfer specific shares of his mutual funds to the Association. He enclosed form 8283 listing the assets he intended to transfer, their cost basis and his idea of current value, along with a request that the form be signed and returned to him.

The Association received the first mutual fund shares in mid-July. Due to delays getting the paperwork through channels, the Association did not receive the second mutual fund until late August 2004. As of the gift dates, the value of one group of shares was approximately \$13,500, and the value of the other group of shares was approximately \$85,000.

Between late May and late August, the Nancy had several telephone conversations with Mr. Jones. During these conversations, he told her that he was in the process of changing his lifestyle and was giving to lots of organizations. He added that the Association was one of his favorites.

Following the transfer of the final mutual fund shares, Nancy prepared a gift acknowledgment letter and new form 8283 that reflected the actual fair market value of the gifts. She then called Mr. Jones and left him a message to advise him the transfers were complete and ask if she could deliver the letter and gift form to him personally. After several attempts, she finally reached Mr. Jones, who declined the offer, stating that she should do nothing and all would be made clear in a few weeks time.

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On the first of the following month, the Association received a letter from an attorney representing Mr. Jones. The letter was a formal request for the return of the gift on the basis that it was made in contemplation of his death and thus revocable under California law. The letter was accompanied by a separate Notice of Revocation and Demand for Return of Gifts that listed the two mutual fund gifts plus a gift of cash.

## **INTERNAL APPROACH**

The situation presented by Mr. Jones was completely new to the Association. Immediate reactions ranged from surprise and disbelief to conviction that the gift was completed and would not be given back. The national senior vice-president of development, the vice-president of finance and technology, the director of financial operations who had received the letter from Mr. Jones' attorney, the chief development officer and the CEO at the local level ("Management") and Nancy (who was the planned giving officer in charge of gifts in Northern California) discussed the matter. Prior to that discussion, Nancy contacted Erik, who was a fellow member of the National Committee on Planned Giving, to get his initial impressions. They quickly agreed that the process by which the Association addressed this situation was going to be very important in ensuring the Association and its directors fulfilled their fiduciary obligation to conserve the organization's assets. They also agreed that Erik's firm, which specializes exclusively in advising nonprofit organizations and their donors, would be available should the Association decide to retain legal representation.

### **The Process**

With input from Erik, Association management and development personnel outlined an internal process that would provide:

- A complete picture of the facts, the legal, moral and ethical issues of the situation.
- Identification of the key parties within the organization to be involved.
- Education for the members of the board of directors regarding their fiduciary obligations.
- Documentation of the board's decision process in order to demonstrate that it acted prudently.

First, the Association promptly responded to Mr. Jones' attorney with a letter asking for clarification and documentation of the alleged cash gift, without taking a position on the attempt to revoke the gift. Additionally, after a discussion of the need for counsel and whether that counsel should come from an Illinois law firm, Association personnel agreed that it would be more efficient to retain the services of Erik's firm. Nancy and the director of financial operations were designated to take the lead on follow-up for this and all future developments, and to keep management and the board advised of all progress.

When the legal research described below was complete, the board met to discuss the relevant law, the uncertainty as to how a court might apply it to the current situation and the likelihood of prevailing and at what cost, both in dollars and beyond the legalities. This took into consideration the mission and values of the organization, as well as the possible negative impact of publicity on general donor relations in the community—the infamous “New York Times test.”

## **The Legal Issues**

In response to the Association’s request for clarification of the alleged cash gift, Mr. Jones’ attorney sent a copy of the disbursement confirmation from the broker. Upon closer scrutiny of the confirmation, the Association concluded that the alleged cash gift was in fact related to the transfer of the mutual fund shares, thereby confirming its records that there had been no cash gift. That was the easy part.

In his cover letter and attached legal memorandum, Mr. Jones’ attorney gave the background of Mr. Jones’ revocation and set forth his legal analysis. The demand for the return of Mr. Jones’ gift was based upon California’s “gift in view of impending death” statute, set forth in section 5700 and following of the California Probate Code. A gift in view of impending death is defined as “one which is made in contemplation, fear, or peril of impending death, whether from illness or other cause, and with intent that it shall be revoked if the giver recovers from the illness or escapes from the peril.” A gift is presumed to be a gift in view of impending death” if it is made “under circumstances which would naturally impress the giver with an expectation of speedy death.” A gift in view of impending death is revoked by the giver’s escape from the peril, and may in fact be revoked by the giver “at any time.”

The memorandum alleged the following:

- Mr. Jones planned to commit suicide.
- he decided to dispose of his entire estate before doing so.
- he made a gift of his entire estate during the summer of 2004.
- he unsuccessfully attempted suicide in August of 2004.
- he had since been discharged with appropriate therapeutic follow-up care.

The attorney argued that Mr. Jones was left destitute and faced eviction from the “life care community” where he had lived for nearly 20 years, and his living and care expenses were going unpaid. His message was clear: for his well being, Mr. Jones needed to have his gift returned.

Prior to beginning his own research on behalf of the Association, Erik determined fairly quickly (in part by monitoring e-mail exchanges on GIFT-PL!) that Mr. Jones made similar charitable gifts to at least four other charities under similar circumstances. In fact, Mr. Jones’ attorney

ultimately disclosed that Mr. Jones had made similar gifts to 13 charities totaling more than \$1.5 million.

Erik's preliminary legal research into this matter revealed a limited amount of California case law interpreting these statutes, some of which the attorney cited in his memorandum. In addition, there was some guidance from other states' courts and legal commentary. Nonetheless, this was hardly a "well developed" area of law.

While it was premature to offer a firm analysis of the legal merits of the case at this stage, Erik was certainly able to advise the Association that the resolution of Mr. Jones' claim would not be clear-cut for either party. To be successful, Mr. Jones would have to prove several facts in order to revoke his gift under Code section 5700, including that:

- the gift was made in contemplation of death;
- the death was imminent; and
- he intended that the gift be revoked if he recovered.

On the other hand, Mr. Jones made certain allegations which, if true, could be relevant, including that:

- he gave away all of his assets (which might help "prove" he intended the gifts be revocable if he did not die); and
- he may be evicted from his care facility for failure to pay his monthly fees (which, if not directly relevant to the legal issues, could be a very persuasive factor at trial).

Erik also reviewed the matter on a very preliminary basis with an attorney specializing in estate and fiduciary litigation. The attorney estimated that the cost to the Association of litigating the case would be, at a minimum, \$50,000. He also noted that Mr. Jones, elderly and now destitute, would likely be viewed by the jury as a very sympathetic plaintiff. That the Association had neither solicited the gift nor had knowledge that Mr. Jones was contemplating death when the gift was made would probably be seen as inconsequential.

Based on Erik's research and the other information it had obtained, the Association authorized Erik to contact Mr. Jones' attorney to request documentation supporting the alleged basis for the revocation. Erik and Nancy suspected that he would be able to prove certain elements of his "case," but that he would have difficulty in proving other elements. For example:

- it was unclear whether intending to commit suicide was within the scope of the statute.
- with a lag time of several months between the initial gift intent (mid-May) and the attempted suicide (the end of August), it might be difficult to prove that death was "imminent".
- it might also be difficult for Mr. Jones to prove he intended that the gifts be revoked should he survive.

## **Ethical Issues and the Focus on Mission**

Both Erik and Nancy recognized the necessity of identifying the non-legal considerations generated by the matter, and both strongly believed that there were significant ethical and public policy questions in play. In this situation, they advised the board to keep the Association's broad mission and constituency, and how they related to Mr. Jones and his situation, in mind when analyzing what course of action to take. Even if the Association had a solid legal argument, which did not appear to be the case, there was the question of whether the gift should be returned for other reasons. If Mr. Jones was in fact now destitute, how could his plight be reconciled with the Association's stated commitment to quality of life for those it serves? And even if this were possible, how would the refusal to return the gift under such circumstances, with or without court intervention, fare in the court of public opinion? How would the Association be perceived if the story were to find its way onto the front page or the editorial page of the local newspaper?

Since the Association has a local office in the town where Mr. Jones lived, Nancy spoke with staff there who confirmed the strong connections between the Association and the retirement living facility on a number of levels. These connections are extremely valuable to the Association's fundraising and program efforts in the community. Maintaining a positive public image and good donor relations would be critical for the Association's future fundraising efforts with other donors. Erik also noted that a news story would not be out of the question, since Mr. Jones' attorney could easily go to the press with a "sympathetic" story. Weighing all the aspects of the situation, including both the legal and the non-legal considerations, was essential to the board's proper exercise of its standard of care.

## **PRELIMINARY RECOMMENDATIONS**

### **Standards Applicable to Association Board**

As an Illinois nonprofit corporation, the national Association was subject to the Illinois Not For Profit Corporation Act and the Illinois Charitable Trust Act. Erik's firm is a California law firm, and not licensed to practice law in the state of Illinois. Accordingly, he could not advise the board on all issues arising under the applicable Illinois law. However, he reviewed the law, and since it was similar to that of California, was able to provide the board with a general discussion of nonprofit board fiduciary duty, based on his knowledge of California law. Erik advised that this analysis should also be generally applicable to the Association board under Illinois law; however, the board should consider having the analysis reviewed and expanded by an Illinois attorney (the Association has no dedicated in-house counsel licensed to practice in Illinois).

The applicable law provided that a nonprofit's board, collectively, is responsible for conducting the corporation's affairs and exercising its corporate powers, which include the power to acquire, hold, and dispose of real property. A board may generally delegate management of the corporation to others, subject to the ultimate direction of the board. The board, therefore, is responsible for ensuring that the Association operates in compliance with all applicable laws. Board members are generally held to a standard of conduct comprised of two separate duties: the duty of loyalty (to act in good faith, in the corporation's best interests, and without regard to personal interests or the interests of any third party); and the duty of diligence (to apply reasonable skill and judgment in managing the affairs of the corporation, devote adequate attention to the corporation's affairs, and act only after making inquiries reasonably required by the situation).

The Association is also tax-exempt under section 501(c)(3) of the Internal Revenue Code (IRC). As such, among other requirements, it must be "operated exclusively for . . . charitable purposes" and "no part of [its] net earnings . . . [may] inure to the benefit of any private . . . individual . . . ." Gifts to individuals who are not members of a charitable class are not permitted by these requirements, and expose the charity to potential revocation of exempt status on audit by the Internal Revenue Service.

### **Options Available to the Board**

Erik concluded that the board had a wide range of options, but that there were certain limitations as well:

**Refuse to return any of Mr. Jones's gift.** A refusal to return any of Mr. Jones's gift would at first glance appear to satisfy the board's duty to preserve its assets, but could result in his filing suit against the Association. The board had to consider that the Association's likelihood of success at trial was far from certain, and the costs of litigation were likely to be significant. In addition, the public relations issue could be very damaging.

**Return entire gift.** The information provided by Mr. Jones's attorney suggested that Mr. Jones' case, albeit a sympathetic one, was far from clear cut. Would simply returning the gift be an inappropriate gift of charitable assets, placing the board at risk of violating its fiduciary duty? Would it be a private benefit transaction, placing the Association's tax-exempt status under IRC section 501(c)(3) at risk? In evaluating this option, the board had to consider that through no fault on the part of the Association, Mr. Jones's gift and subsequent attempt to revoke it had resulted in unforeseen expenses to the Association.

**Offer to Settle.** From the very beginning of the matter, Erik, Nancy and members of management had a common goal: achieving the best possible outcome for all concerned, including Mr. Jones, while protecting the Association's interests and ensuring the board satisfied its fiduciary duty. Erik advised that the terms which the board might offer would, of course, be a function of many factors, including the nature of the documentation presented by Mr. Jones's attorney, the relative strength of the Association's position, the board's view of the ethical issues involved, and the board's tolerance for potential adverse publicity. Erik also noted that it would be beneficial to try and settle the dispute in a reasonable and prompt fashion.

One suggestion was that any settlement offer include reimbursement for the costs incurred by the Association relating to the gift. This approach had a certain appeal, since the Association would be made whole for its costs while at the same time avoiding the time, expense and potential adverse publicity of a drawn-out contest. In addition, if the settlement approach were taken, it would be important for the Association to obtain a release of liability from Mr. Jones, and to ensure that he did not attempt to take an income tax charitable contribution deduction for the value of the gift.

**The Planned Gift Alternative.** In addition to the idea of returning some or all of the gift (ideally less the Association's out-of-pocket expenses), the settlement alternatives included various planned gift options.

1. Irrevocable Bequest: This approach would entail returning the gift to Mr. Jones in exchange for a written, binding pledge of assets to be paid from his estate. While this arrangement would provide maximum funds to Mr. Jones, it was viewed as less attractive than a life-income option; in particular, if Mr. Jones exhausted his funds during life, the Association's rights under his pledge would be worthless.

2. Charitable Gift Annuity (CGA): A CGA would be the most easily managed planned gift alternative, aside from an irrevocable bequest. One issue was whether Mr. Jones would require a higher payout than the 11.3 percent suggested by the ACGA rates in effect at the time (the Association would be unable to provide a higher rate under California law governing CGAs). Would it be appropriate in this case for the Association to offer a solution that obligated the Association to continue making payments even if Mr. Jones outlived the funds contributed?

3. Charitable Remainder Trust (CRT): A CRT would have the advantage of terminating if and when the assets were exhausted. However, who would act as trustee? Further, given the relatively small corpus involved, a high payout coupled with the necessary costs to administer the trust might lead to the rapid erosion of the trust assets. Again, even if these problems could

be surmounted and the Association offered a high income payout, income alone might not solve Mr. Jones's problem.

Because of the number of charities that received gifts from Mr. Jones, the Association briefly considered joining with other beneficiaries to create one CRT to hold the combined gifts, with each charity named as a remainderman on a pro-rata basis. However, it was soon apparent that there was a lack of consensus among the first four organizations the Association spoke with as to how they would address Mr. Jones' demand for return of the gifts.

4. Irrevocable Nonqualified Trust: Since it was unlikely that Mr. Jones needed the income tax benefits of a qualified charitable remainder trust, the attorney suggested a nonqualified or "defective" charitable remainder trust that would provide Mr. Jones with access to principal as well as net income. The trust provision for when trust principal could be invaded for his benefit would have to be tightly worded, so payments could be made only for specific purposes. Finding a trustee to manage such a trust was expected to be difficult.

5. The Combination Option: This option involved offering to return a portion of the gift (to provide Mr. Jones with funds) and retaining the balance as a planned gift. While this option would reduce the amount available for the planned gift, hence reducing the income payments, it would give Mr. Jones an immediate source of capital. A CGA was considered, as well as a CRT if it became possible to enlist most of the charities to which Mr. Jones made gifts.

Given that the initial information provided by Mr. Jones' attorney was relatively complete and persuasive, it appeared that attempting to settle this matter should be characterized as a "good faith" attempt to settle a dispute, and thus an appropriate exercise of the Board's fiduciary duty. The law recognizes shades of grey in these areas, and (at least in California) expressly gives the Board the freedom to determine what is in the Association's best interests under *all* the circumstances.

## RESOLUTION

Erik called Mr. Jones's attorney and requested specific information regarding the allegations as to Mr. Jones medical and financial situation, as well as substantiation of all of his gifts, and a copy of the contract with the retirement living facility. During the conversation, Mr. Jones's attorney indicated he had contacted all the charities, and had received responses from "one end of the spectrum to another." He expressed an understanding of the Association's need for due diligence, and contrasted it with one organization that sent the entire gift back immediately after getting his initial letter, with no investigation of his "allegations" whatsoever.

The following week, Erik received a letter from Mr. Jones's attorney enclosing the hospital discharge summary from Mr. Jones's attending physician, a list of the charitable organizations to which gifts were made, a separate list of the amounts of the gifts to each of the charitable organizations, a copy of statements from the living facility for the period of and after the suicide attempt, and a copy of the life care agreement with the facility. Mr. Jones's attorney concluded by stating that Mr. Jones was open to a settlement proposal, and would consider some form of annuity, adding that one organization had converted its gift to a CGA.

A review of the requested information confirmed that Mr. Jones could easily support some of the elements of his claim, while other elements were open to argument. Overall, however, the information was sufficiently complete and persuasive that the board decided to attempt to settle this matter on a basis that did not leave the Association "out of pocket" for the legal and other expenses incurred. Some Board members were inclined to return the gift outright, believing it was the right thing to do. However, it was pointed out that because Mr. Jones' attorney had opened the door to a life-income gift settlement, the Board now had a duty to explore that option. Accordingly, the Board authorized its attorney and the PGO to proceed with proposing a CGA in the amount of Mr. Jones' gift less the expenses incurred.

Before contacting Mr. Jones's attorney, Erik, Nancy and the Association's vice-president of finance discussed some of the practical and technical aspects of implementing the settlement. These included certain tax issues, a full discussion of which is beyond the scope of this article. For example, the Association had to determine on what date the gift annuity agreement became effective, and what asset was contributed for the CGA. Mr. Jones, on the other hand, had to determine on what date he believed the gift was complete, and whether he was entitled to a charitable contribution deduction.

Following Erik's phone call to Mr. Jones's attorney, and a letter documenting the details discussed in their conversation, Mr. Jones agreed to a charitable gift annuity for the net amount, to be effective as of the first of the year (it was late December at this point) with a rate of 11.3 percent as recommended by the American Council on Gift Annuities, payable monthly. The attorney then prepared the formal Settlement Agreement and Mutual Release. Besides reciting the basis for the settlement and the mutual release and discharge of each party, the agreement specifically provided for the return of the initial Form 8283 and that the Association made no representation as to whether the settlement would generate an income tax charitable contribution deduction. Mr. Jones would look solely to his advisors regarding his tax consequences.

While the Agreement was being circulated for review and signature, Nancy prepared an illustration of the charitable gift annuity based on the Agreement and the paperwork Mr. Jones would execute to create the gift annuity. As soon as Mr. Jones signed the Agreement, Nancy sent

these to Mr. Jones's attorney with a cover letter that reiterated the need for Mr. Jones to consult his tax advisor.

## **FINAL THOUGHTS**

There are many "morals" to this story, but one is "process is important." At the board level, proper process and documentation is key to demonstrating that the board fulfilled its fiduciary duty and satisfied its standard of care. The Association board collected the facts, evaluated the strengths and weaknesses of its position, explored its options, and obtained legal advice. As a result, when it was time to make a decision, the board could demonstrate that it had acted prudently. At the staff level, all of the interested parties were brought into the discussion early, so there were no internal "surprises" later on. Contrast this to one of the other charities, where the finance division reached a settlement with Mr. Jones without ever involving staff in the development department, who learned about the matter only when the settlement was dropped in their laps to implement!

The Association's attention to proper process was not lost on Mr. Jones and his attorney. Several months after the settlement was reached and the Association started making monthly gift annuity payments, Mr. Jones sent a short note to Nancy, expressing his appreciation for the Association's cooperation in helping him to return to financial health. He noted how good it felt "to be able to help [the Association] and know that [the Association] is helping me." Mr. Jones's attorney was also complimentary of the way in which the Association handled the matter, saying he wished more organizations were as good to work with. Now that's the definition of a good planned gift!

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