

CHICAGO-KENT COLLEGE OF LAW

FINAL EXAMINATION: NONPROFIT LAW

Professor Brody

Fall Semester, 2008

This examination consists of 9 pages, including this cover page.

Please put your examination number (no name) on each bluebook (or typed pages) handed in.

INSTRUCTIONS:

1. Once you begin the exam, you must stop 3 hours later. BY SUBMITTING THIS EXAM, YOU AGREE THAT THE HONOR CODE APPLIES TO THESE CONDITIONS. PLEASE ENTER HERE:

Exam number (no name): _____
Date and time you began the exam _____
Date and time you stopped the exam _____

2. You may consult any written materials, as well as your notes and outline. However, you may not access the CD-ROM provided with the course material, or the contents of the CD-ROM if you downloaded them to your hard drive. **During this exam you may not speak with, email, or otherwise communicate with any other person.** Afterwards, **you may not speak with, email or communicate with *anyone* about the exam until Saturday, December 20.**

3. The questions are weighted in the same proportion as the amount of time indicated at the beginning of each question). **There are a total of 180 points** (180 total minutes). Partial credit is given. Watch your time, and answer all parts of all the questions.

4. You need not quote from statutes, cases, or other authority, but you must cite generally to the appropriate authority or doctrine, if any, to receive credit. All answers must be recorded in your bluebook(s) or typed answer sheets. You will not receive credit for irrelevant or illegible answers. I can understand any standard abbreviations (or if you want to make one up, explain it).

5. While I do not impose a specific page limit, if you are typing your exam, please do NOT cut and paste explanatory text from your outline – just answer the question being asked, as if you're hand-writing your exam.

6. If you are uncertain about the facts, governing law or anything else in the exam, briefly state a reasonable assumption and why you are making the assumption, and then answer the question accordingly. If two assumptions appear equally reasonable, you may also state how the analysis would differ if you made a different assumption.

GOOD LUCK!

I. [40 minutes total for this question]

A November 13, 2008 story in the *New York Times*, called “Theater Director Resigns Amid Gay-Rights Ire” (by Jesse McKinley), reads, in part:

SACRAMENTO — The artistic director of the California Musical Theater, a major nonprofit producing company here in the state’s capital, resigned on Wednesday in the face of growing outrage over his support for a ballot measure this month that outlawed same-sex marriage in California.

The artistic director, Scott Eckern, came under fire recently after it became known that he contributed \$1,000 to support Proposition 8, which amended the state Constitution to recognize only male-female marriages. The measure was approved by 52 percent of California voters on Election Day. (Same-sex marriages had been performed in California since June.)

In a statement issued on Wednesday morning, Mr. Eckern said that his donation stemmed from his religious beliefs – he is a Mormon – and that he was “deeply saddened that my personal beliefs and convictions have offended others.”

His donation was brought to light by online activists angry about the measure’s success at the polls.

“I understand that my choice of supporting Proposition 8 has been the cause of many hurt feelings, maybe even betrayal,” Mr. Eckern said. “It was not my intent. I honestly had no idea that this would be the reaction.”

But the swift resignation was not met with cheers by those on either side.

Marc Shaiman, the Tony Award-winning composer (“Hairspray”), called Mr. Eckern last week and said that he would not let his work be performed in the theater. “I was uncomfortable with money made off my work being used to put discrimination in the Constitution,” Mr. Shaiman said. He added, however, that the entire episode left him “deeply troubled” because of the potential for backlash against gays who protested Mr. Eckern’s donation.

“It will not help our cause because we will be branded exactly as what we were trying to fight,” said Mr. Shaiman, who is gay. “But I do believe there comes a time when you cannot sit back and accept what I think is the most dangerous form of bigotry.”

Supporters of the marriage ban said that critics of Mr. Eckern were attacking freedom of expression, and they chastised the theater’s board for subjecting Mr. Eckern to a political litmus test.

“No matter your opinion on Prop. 8, we should all agree that it is wrong to intimidate or harass anyone for exercising their constitutional rights,” said a letter to the theater’s board president on Tuesday by Frank Schubert, campaign manager for Protect Marriage, the leading group behind the ballot measure.

For its part, the theater disavowed Mr. Eckern’s donation and issued only a brief statement on Wednesday accepting his resignation, while emphasizing that it would not “impinge on the rights of its employees to engage in political activities.” A longtime employee, Mr. Eckern had been artistic director since 2002.

The outrage over Mr. Eckern and the subsequent dismay voiced by Mr. Shaiman are the most recent evidence of the tension running through the entertainment industry since Election Day, particularly in California.

Several prominent gay entertainers have expressed anger about the vote, including the singer Melissa Etheridge, who said she would refuse to pay California state taxes because she was “not a full citizen” and called on other gay men and women to do the same.

* *

Mr. Eckern did not respond to requests for an interview made to an outside publicist and the production company, which books shows into three Sacramento theaters, including a handsome new cabaret a block from the governor’s mansion. In his statement Mr. Eckern said that he would donate \$1,000 to a gay-rights group, adding that he respected gay people, including a sister who is a lesbian.

“I am loving and supportive of her and her family, and she is loving and supportive of me and my family,” said Mr. Eckern, who is married with children. “I definitely do not support any message or treatment of others that is hateful or instills fear.”

* * *

Base your answers to the questions below on the facts as described in this news story, and assume further (the story doesn’t say) that the board of directors of the theater fired Eckern for his donation to defeating Prop. 8.

- a. **[20 minutes]** Has the theater violated Eckern’s constitutional rights by firing him for this reason? Did the board exercise sound business judgment in firing him? Discuss.
- b. **[20 minutes]** Has Eckern jeopardized the theater’s federal income-tax exemption by his donation? Would the theater have jeopardized its exemption by publicly declaring its opposition to Prop. 8? Discuss.

II. [One hour and 40 minutes – 100 minutes – total for this question]

[Note: I've marked in the left margin the text particularly relevant to each of the five questions below, although you might refer to additional facts in your answers.]

On November 21, 2008, the *New York Times* reported:

Q.a The [California] state attorney general has begun an inquiry into the financial status of the Museum of Contemporary Art in Los Angeles after it announced that it was seeking new financing to shore up its rapidly shrinking endowment. The museum said it received a letter from the attorney general's office, which oversees nonprofit institutions in the state, requesting "information and documents related to the museum's finances." People who have been briefed on the museum's financial situation said its endowment had fallen to less than \$10 million, about half the level of a year ago.

More details are available from a November 19, 2008 story by Mike Boehm in the *Los Angeles Times* entitled "MOCA Faces Serious Financial Problems." This story read, in part:

Los Angeles' prestigious but chronically underfunded Museum of Contemporary Art has fallen into crisis. Museum Director Jeremy Strick said MOCA is seeking large cash infusions from donors, and this week he did not rule out the possibility of merging with another institution or sharing its collection of almost 6,000 artworks.

Federal tax returns show that even before the current national crisis, MOCA had been draining its reserves to pay operating expenses. In the meantime, the museum's staff has grown.

Unlike the Los Angeles County Museum of Art, which is partly controlled by the county, MOCA receives minimal government funding. Its annual budget has grown to exceed \$20 million, but it relies on donors to pay about 80% of its expenses. When the gifts have fallen short, as they have more often than not during Strick's nine-year tenure, the museum has gone into its savings.

In recent years, the museum has averaged 250,000 visits annually to view critically acclaimed exhibitions and a collection boasting works by such post-World War II masters as Jackson Pollock, Robert Rauschenberg and Mark Rothko.

Q.b By one important measure – "unrestricted assets," money that can be used for any purpose – MOCA is in dire straits. Its federal tax returns show that early in this decade the museum had spent all \$20 million of its unrestricted funds to meet routine operating costs. By mid-2007, it had borrowed an additional \$7.5 million from "restricted"

accounts, even though those are designated by donors for specific uses, such as education or buying art.

In an interview this week, Strick would not disclose more recent financial figures. But he acknowledged that the national economic crisis had further flattened the museum's cushion. MOCA's investment portfolio was worth \$20.4 million in mid-2007, down from \$36.2 million in mid-2000.

Most investment portfolios have lost significant value this fall.

However, the number of museum employees, including part-timers, has risen from about 150 early in this decade to about 200 in recent years. Strick said that was due to increased educational programs and the addition of a curatorial department for architecture and design.

* * *

Q.c Strick said MOCA must sharply accelerate its fundraising to ensure its continuing health. The director planned to meet with MOCA's Board of Trustees this afternoon to discuss a range of options. He said talks were proceeding "with a number of potential partners about a variety of arrangements," but he insisted that a dissolution or takeover of MOCA by another institution was not an option.

"All the possibilities being explored involve MOCA retaining its identity, continuing its program, expanding its collection," he said. But he added: "I think it is time for this city to step forward and offer the kind of financial support commensurate with the work being done."

* * *

Q.d An irony of MOCA's plight is that, thanks to the appetite of wealthy international collectors, the market value of its prime pieces has soared. Corporations and individuals routinely sell sculptures and paintings in an economic pinch, but a museum that did so would be violating its reason for existing, which is keeping art in the public domain. The codes of ethics of both the American Assn. of Museums and the Assn. of Art Museum Directors, although not legally binding, specify that the only acceptable reason for selling artworks from a public collection is to raise money for buying other, presumably more desirable, pieces.

Strick said it's not unusual for business-minded members of any museum board to ask about selling art to relieve a cash crunch. But the unchanging answer, he said, is that it can't be done because "our mission is preserving and protecting this collection."

These developments prompted the *L.A. Times*' art critic, Christopher Knight, to publish an "An Open Letter to MOCA's Board of Trustees" on November 20, 2008. Knight tore into the board, charging, in part:

Ten years ago, in the spring of 1998, *The Times* reported that MOCA was operating on a \$10-million annual budget with a nearly \$50-million endowment. A ratio of 1 to 5 – or even 1 to 4, if you were exaggerating numbers then – for budget to endowment is pretty good for a nonprofit.

Last year, by grim contrast, MOCA was reportedly operating on close to a \$20-million annual budget with a \$20-million endowment. That's a ratio of 1 to 1 – the technical term for which is "suicide."

With ballooning expenses and a shrinking endowment rumored to be about \$7 million – at most – you have gone from covering between 20% and 25% of your annual budget in 1998 to covering as little as 2%. You steadily pushed the museum further and further out onto a ledge, so that when the global economy finally tanked, MOCA went into free-fall.

Q.a Now that's a scenario the California attorney general, whose office oversees nonprofits such as yours, could use as a cautionary case study. As trustees your first responsibility is fiduciary, and in that you have been a flop.

Spending down your endowment is the equivalent of a farmer eating the seed corn. The first time you dipped in, sirens should have sounded. The museum's director and the board's finance chairman should have put an immediate stop to it, but didn't. That is dereliction.

* * *

The rescue plans being talked about illustrate the problem. Two of them are frankly shameful.

Q.d One would rent your incomparable painting and sculpture collection to a local foundation – controlled by one of your own trustees! – in exchange for some sort of multimillion-dollar annuity. The other would be a flat-out sale of it to another museum, so that you might shift the fundraising burden elsewhere, take the revenue and continue as an exhibition-only venue.

Yes, we live in a market economy, where art is bought and sold; but one of the glories of an art museum is that it provides refuge from the crude commercial world. When art enters a museum's permanent collection, it leaves the marketplace behind. That your first instinct is apparently scheming to monetize your extraordinary collection shows that you are not trustees, you are art dealers in disguise.

Q.c The third plan I've been told about is even worse – total Armageddon. A merger with the Los Angeles County Museum of Art, in which the collection and selected staff would move to the Mid-Wilshire campus and the downtown facilities would close, would mean MOCA would cease to exist. You seem to be willing to allow your own institution, one whose remarkable program and astounding collection are the envy of cities around the world, to simply disappear. Dumbfounding.

Q.a Forgotten in this ridiculous saga are the Three Gs of trusteeship. Your job is to give art and money, get art and money, and guard the art and money you have gotten. So, here is what you need to do to actually rescue MOCA. It is not complicated, but it will require work.

Q.e You must call an urgent board meeting, gather round the table, pull out your checkbooks and calculators and stay in that room until you have cobbled together at least \$25 million. That will buy you a little time – 18 to 24 months – during which you must do two things.

First, you cut MOCA's unaffordable budget. Second, you craft a strategic plan.

* * *

Based on the facts as reported above – and ignoring any peculiarities of California law –

- a. [15 minutes]** Discuss whether the attorney general has a cause of action against the museum's board members to compel them to raise funds or make contributions to restore the lost value of the endowment.
- b. [10 minutes]** Discuss whether the attorney general has a cause of action against the museum's board members if they approved "borrowing" restricted gifts to fund expenditures.
- c. [15 minutes]** Discuss whether the board could merge the museum with – and transfer its assets to – another Los Angeles cultural institution consistent with its fiduciary duties.
- d. [30 minutes]** Would a decision by the board to sell or lease one or more of the museum's paintings to raise operating capital be a breach of fiduciary duty? Would it matter if, as suggested, the transaction is with another charity controlled by a board member? (Ignore the art critic's description of that other institution as a "foundation.") Discuss.
- e. [30 minutes]** Assume that the board develops a strategic plan to bring a suit to modify the restrictions on enough gifts to allow the museum to sell those gifts to raise funds for operations. What is such a legal procedure called, and how would the court likely rule and why?

III. [40 minutes total for this question]

In a story called “Goodwill Hunting,” published in the *New York Times* on November 2, 2008, Rob Walker wrote:

In the first eight months of 2008, sales at Goodwill stores in the United States and Canada increased by 7 percent over the same period last year. While that obviously runs counter to trends being reported by most retailers these days, it’s hard to say whether it counts as good news that more people are evidently buying secondhand goods. After all, many of us probably don’t think of Goodwill in terms of retail; we think of it in terms of charity.

But operators of some Goodwill stores have been making efforts to prod us to think a little differently, or perhaps more expansively, about the brand – and quite possibly the present economic gloom has primed us to be more open to that idea. Washington-area Goodwills, for instance, promote their stores with Webcast fashion shows as well as a popular blog, dcbgoodwillfashions.blogspot.com, which highlights great bargain finds at their shops. Goodwill Industries of Central Indiana has commissioned advertising for its stores that emphasizes pleasurable bargain hunting at least as much as altruism. Goodwill Industries in the San Francisco area has worked with the Joe Boxer founder, Nicholas Graham, on the creation of a line of new clothes made out of discarded items, under the name William Good.

The more than 2,200 retail stores (counting international locations) bearing the Goodwill name all follow certain guidelines set down by Goodwill Industries International. But the management and operation of those stores are decentralized: there are 168 North American “member agencies,” each rooted to a particular geographic area. This means that donations stay within a particular region; it also means that stores in different areas can pursue different promotional strategies. Goodwill Industries of Central Indiana, for instance, was operating 23 stores in Indianapolis and surrounding areas in 1996, when its management decided to take the unusual step of hiring an advertising agency as a way to increase sales, says Cindy Graham, the vice president of marketing. Young & Laramore, an Indianapolis agency, helped devise the campaign to position Goodwill stores less as charity and more as discount retail. This meant changing the perception of potential shoppers who might think of Goodwill as a place where poor people bought castoffs, not as a competitor to Wal-Mart.

Since then, Young & Laramore helped create two dozen TV spots, mostly lighthearted and upbeat and often featuring an amiable young guy in a Goodwill uniform. The Goodwill Guy picks through donations bearing brand names like Ralph Lauren and Donna Karan or tells the “scary story” of the woman who missed out on the perfect bolero jacket because she didn’t buy it on the spot. In some of the ads, the Goodwill Guy presents more traditional charitable messages about how your donations help those less

fortunate, but always with a light tone. Perhaps the most cunning of the ads combines these ideas, making a case that shopping (at a Goodwill store, anyway) is in and of itself an act of charity.

Today, Goodwill Industries of Central Indiana has expanded to 40 locations, and its store revenues have grown apace – 2007 sales were around \$45 million, up 17 percent from 2006. Graham says area population growth, improved customer service and careful management have been factors, too. But, she figures, “the advertising is a big part of the increased sales.” And elements of the Central Indiana campaign have been used by Goodwills in 72 other markets in the United States and Canada, according to Ann Beriault of Young & Laramore.

Goodwill Industries of Greater Washington has taken a different approach but with similar goals. For the past few years, it has organized a Fashion of Goodwill runway show and Webcast featuring models in outfits plucked from its stores (and subsequently auctioned off). Last year, the retail marketing manager Em Hall took on the role of D.C. Goodwill Fashionista, whose engaging thrifter blogging about discoveries in that region’s nine stores attracted attention and even won her an invitation to blog from New York’s Fashion Week.

None of this is to suggest that the nonprofit is backing away from its altruistic mission. The charity says that 84 percent of its total revenues go toward job training and placement and other programs. Even so, these efforts suggest an element of the Goodwill idea that is not simply about good will but also, to be blunt, about how there’s something good in it for you.

* * *

Assume all of the items sold by the Goodwill stores are donated. Do the marketing activities of the various Goodwill stores, as described in this story –

- a. [20 minutes] Jeopardize their federal income tax exemption? Why or why not?
- b. [20 minutes] Result in their sales income being subject to the unrelated business income tax (UBIT)? Why or why not?

YOU’RE DONE – CONGRATULATIONS, AND HAVE A GREAT HOLIDAY!