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Art Trumps Creditors' Rights Against a Dissolving Non-Profit Museum

STEVEN A. MEYEROWITZ AND VICTORIA P. SPEARS

With the economy continuing to struggle, art museums and other similar not-for-profit public interest institutions face a difficult future. In the event they are forced to dissolve, can their collections be used to pay creditor claims? The authors analyze a recent decision by an intermediate New York appellate court that sheds significant light on this question.

Formal codes and guidelines governing art museums and similar institutions limit their ability to sell their art or other parts of their collection to pay ongoing expenses.[1] What happens, though, when an art museum or other similar not-for-profit public interest entity dissolves? Can a court order the sale of some or all of the items in the dissolving institution's collection and require that the proceeds be paid to settle creditors' claims?

Perhaps surprisingly, in a state known for some of the world's leading art and history museums, the issue has only just been decided in New York. The recent intermediate state appellate court decision in *Matter of Friends for Long Island's Heritage*[2] was the first court opinion in New York on this subject.

The principal issue decided by the appellate court in *Friends* was whether, in a judicial dissolution proceeding pursuant to New York Educa-

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tion Law §216-a(4)(d)(13) and New York Not-for-Profit Corporation Law §102(a)(2)(E), a court could order that assets held for a limited purpose by the dissolving entity be used or sold to pay its creditors, and, if so, whether there were any limitations on the court's discretion in doing so.

Museums, art lovers, donors, creditors and courts are likely to find significant guidance in the decision when — not if — these concerns arise in New York, or elsewhere, in the future. The appellate court ruling, however, is not likely to comfort creditors. It is, instead, a clear statement of support for art in our society.

BACKGROUND

As the appellate court set forth in its decision, in 1964, Friends of the Nassau County Historical Museum was granted a provisional charter, made absolute in 1969, from the New York State Board of Regents to operate as a not-for-profit educational corporation. Its purpose was to assist the Nassau County Historical Museum (the "Museum") in the "development and promotion of a historical interpretation and educational program… including activities of the…museum, county historic sites and Old Bethpage, a village restoration," and its duties included soliciting members of the public for donations of historical materials for the Museum. In 1980, the corporation changed its name to Friends for Long Island's Heritage ("Friends").

From 1964 until 2002, Nassau County, on western Long Island, acquired approximately 35,000 objects for its museum collections through Friends. Friends obtained those objects through purchases and gifts. Friends also managed Nassau's landmark properties pursuant to a license agreement. Friends also established a relationship with the Suffolk County Department of Parks, Recreation and Conservation.

In 1997, the president of Friends, Gerald S. Kessler, and Mark Levine executed a "Loan and Gift Agreement," which provided that the "Donald and Marsha Levine Ceramics and Glass Collection" (the "Levine Collection"), would be received at the collection center at Sands Point, in Nassau County, where a determination would be made as to which items would become part of the permanent collection, and which items would be sold. Sale proceeds would be placed in a restricted fund to be used to acquire

additional ceramics to enhance the Levine Collection, to establish a center for the study of English ceramics at Sands Point, to provide funds for the restoration of pieces in the collection, and to provide for the payment of administrative expenses related to the Levine Collection. The agreement also provided that, even after acceptance into the collection, selected pieces could be sold, and the proceeds would be placed in the restricted fund. Nassau already possessed another collection of ceramics at Sands Point, the Buten Collection of Wedgwood Ceramics (the "Buten Collection"), which was on display at a park known as the Sands Point Preserve.

In 2000, Friends received $250,000 (the "Campbell Fund") from the estate of Jeanette H. Campbell pursuant to a provision in her will that stated that the bequest was made:

> provided that [Friends] establish a permanent endowment fund with said bequest, the earnings from such fund to be used for the maintenance and repair of the buildings at the Old Bethpage Restoration in Bethpage, New York.

At some point, Nassau became dissatisfied with Friends' performance of its obligations and, in December 2002, it terminated a 1974 agreement under which Friends was to maintain, use, and preserve certain of Nassau's landmark properties. Between 2002 and 2005, Friends ceased acquiring objects for Nassau's museums. Additionally, in September 2004, after an audit by the Suffolk County Comptroller of Friends' performance between 2000 and 2002 of certain Suffolk County obligations, Suffolk County also terminated its agreements with Friends.

THE DISSOLUTION

In late 2004, Friends' trustees adopted a resolution to dissolve the corporation. In May 2005, the New York Board of Regents approved judicial dissolution of Friends, and in December 2005, Friends filed a petition, amended in December 2006, for judicial dissolution pursuant to Not-for-Profit Corporation Law §1102. Various entities and individuals made claims against Friends. These claims included secured claims to-

taling $438,422.39 by the U.S. Small Business Administration ("SBA") and the New York Community Bank (the "Bank"); unsecured creditors' claims totaling $266,045.43; and employees' claims totaling $44,100.70. In addition, Friends' president made a claim, which Friends disputed, for additional compensation, and Nassau and Suffolk Counties alleged that Friends owed them a total of approximately $1,800,000 for breach of contract; Suffolk made an additional claim as well.

Friends' plan for dissolution included a sale of its assets, including the Buten Collection and the Levine Collection, with the proceeds to be used to pay its debts. Friends eventually agreed that it did not own the Buten Collection, and withdrew it from the plan for dissolution in an amended petition filed in December 2006.[3]

The Wedgwood Society of New York, which brought about the donation of the Levine Collection to Friends, moved for leave to intervene in the proceeding, and its motion was granted in February 2007.

In the Spring of 2007, Nassau sought an order from the trial court determining that Education Law §220(4) and 8 NYCRR 3.27 precluded the sale of "museum objects" that were claimed by Friends in order to pay Friends' creditors. By order entered November 14, 2007, the trial court denied the motion, finding that the rule requiring that assets held by a corporation such as Friends for a limited purpose be used only for that purpose, and not for general operating costs or payment of debts, did not apply in the dissolution of the corporation. The court held that Friends, under the direction of the court, could sell such objects to pay its debts and the costs of dissolution.

Nassau took an appeal from that order, but then reached a proposed resolution with the secured creditors and Suffolk, which Friends did not oppose, and the appeal was eventually withdrawn. Under the terms of the proposed resolution, which was termed a "settlement," Nassau agreed to the sale of the Levine Collection and the use of the proceeds of that sale, as well as the Campbell Fund, to pay the secured creditors the principal amount of their loans to Friends, with the remainder of the proceeds to pay the valid claims of unsecured creditors.[4] The secured creditors agreed to waive any shortfall in the event such assets were insufficient to satisfy the principal. Further, Nassau and Suffolk agreed to waive any claims they had against Friends for

breach of contract. Suffolk conditioned its approval of the "settlement" on its regaining control of a bank account containing approximately $56,000 in funds held for the Suffolk County Advertising and Sports Funds, and also upon waivers of any claims against it by creditors of Friends.

At a conference held on January 17, 2008, the trial court, having already determined that "museum objects" could be sold to satisfy Friends' debts, identified issues for the parties to address in assisting it to determine whether it would approve the "settlement." Those issues included whether the court had the authority to order that restricted funds (i.e., the Campbell Fund) be used to partially satisfy the claims of secured creditors and whether it had the authority to order the sale of the Levine Collection to partially satisfy the claims of secured and unsecured creditors.

Nassau, Suffolk, the SBA, and the Bank submitted papers arguing that the trial court had the authority to order use of those assets to satisfy creditors and argued in support of approving the settlement, and the Attorney General and the State Education Department, jointly, the Wedgwood Society, and the Agricultural Society of Queens, Nassau and Suffolk Counties, Inc., submitted papers arguing, essentially, that the trial court did not have such authority, and objecting to the settlement.

The trial court issued its decision and order in September 2008. Acknowledging the tension between the principles that "items donated to a historical entity for a particular use cannot be used to pay the expenses of the historical entity," and the "statutory authority which states that the court, in the exercise of its discretion, shall authorize the sale of assets of a liquidating non-profit corporation to pay its debts," the trial court determined that it had the authority to order the use of the Campbell Fund and the sale of the Levine Collection, with the proceeds of the sale to pay Friends' creditors. The trial court reasoned that the law limiting the use of restricted assets to fund operating expenses did not apply to the payment of debts during dissolution.

The trial court also found, however, that it had the discretion to determine which assets would be sold to pay creditors. In exercising that discretion, the trial court declared that it was required to consider the "donative intent attached to hundreds of museum objects against the expressed intent impressed upon certain assets." Further, the trial court considered

whether the use of the Campbell Fund to pay debts would impact negatively on the Old Bethpage Village Restoration, the support of which was the main purpose of the Campbell Fund. The court found that, inasmuch as Nassau had agreed to continue to support Old Bethpage Village Restoration, use of the Campbell Fund to pay Friends' creditors was "less of a[] conundrum" than was the proposed sale of the Levine Collection.

The trial court noted that there was "no objective proof which has emerged over the several years during which this proceeding has been pending which would enable [Friends] to establish ownership of objects or artifacts now in the possession of Nassau County," and that no one had sought to undertake that "cumbersome and expensive task." The trial court found that Friends, therefore, was "for all practical purposes without assets." Moreover, it found that the claims of Friends' creditors were valid.

The trial court concluded that the Levine Collection had no particular importance to Long Island; none of the pieces came from Long Island, and Mark Levine had chosen a Long Island charity for his parents' collection only because his father had spent part of his life in Great Neck. Moreover, the Levine Collection had not been displayed to the public, because Nassau's museums did not have the facilities to properly display it. The trial court concluded that "[i]f indeed the public does suffer a loss by the removal of the Levine [C]ollection it is at [most] a loss of a treasure it never saw and enjoyed." Consequently, the trial court determined that it would approve the settlement. An appeal brought the dispute to the Appellate Division, Second Department.

THE STATUTES

In its decision, the appellate court explained that the determination of the appeal required the examination of several statutes. First, inasmuch as Friends was chartered by the Board of Regents under Education Law §216, it was an "education corporation" under Education Law §216-a, which provided for the applicability to such corporations of the Not-for-Profit Corporation Law ("N-PCL"), but with certain provisos, and "adjusting provisions." The appellate court added that important among the provisos was Education Law §216-a(4)(a), which provided:

> If a provision of the not-for-profit corporation law conflicts with a provision of this chapter [the Education Law]…, the provision of this chapter…shall prevail and the not-for-profit corporation law shall not apply in such case. If an applicable provision of this chapter…relates to a matter embraced in the not-for-profit corporation law but is not in conflict therewith, both provisions shall apply.

The appellate court then observed that, pursuant to N-PCL 513(a), a not-for-profit corporation (an "NFP") had "full ownership rights" in all assets given or bequeathed for a specified purpose; such assets were not held by an NFP in trust. Nevertheless, it continued, the rights of an NFP were not without restriction. Pursuant to N-PCL 513(b), the "governing board" of the NFP "shall apply all assets thus received to the purposes specified in the gift instrument and to the payment of the reasonable and proper expenses of administration of such assets." Assets held for a specific purpose by a "Type B" NFP, such as Friends, must be used for that purpose and the "reasonable and proper expenses of administration of such assets."[5] Further, it stated, accounts relating to those assets must be kept "separate and apart from the accounts of other assets of the corporation."[6]

The appellate court explained that an early application of the restriction inherent in the statute was *Saint Joseph's Hosp. v. Bennett*.[7] In that case, the charitable corporation received a bequest from a will, which instructed that the bequest was "to be held as an endowment fund and the income used for the ordinary expenses of maintenance."[8] New York's highest court, the Court of Appeals, rejected the corporation's attempt to use portions of the principal and income to pay its mortgage debt or in furtherance of corporate purposes other than the ordinary expenses of maintenance. While holding that the bequest did not create a trust, the Court of Appeals held that the corporation was nonetheless required to use it for the purpose specified.[9]

Given this, the Second Department found in its *Friends* decision that it was "clear that assets held for a particular use may not be used for other corporate purposes in the operation of the NFP, including for payment of debts."

DEBTS AND DISSOLUTION

With respect to dissolution, the appellate court explained that New York Education Law provided for a procedure to be applied when the Board of Regents had dissolved an educational corporation: If the educational corporation had assets, a petition must be made to a New York court for "an order directing the disposition of any and all property belonging to the corporation."[10] After certain procedural requirements had been met,

> *[t]he court shall direct the sale of sufficient designated assets to pay any outstanding debts and the cost of dissolution*. The regents and the board of trustees may present to the court their recommendation as to the disposition of the remaining property of the corporation if there be library books, objects of art or of historical significance, as far as possible they shall not be sold but shall be transferred to libraries, museums or educational institutions willing to accept them. If a charter contains a provision indicating a proposed disposition of the assets in case of dissolution, such provision shall be followed by the court in its order as far as practicable. If there be any surplus moneys after payment of debts and the expenses of liquidation, the court may direct that the same be devoted and applied to any such educational, religious, benevolent, charitable or other objects or purposes as the said trustees may indicate by their petition and the said court may approve.[11]

The appellate court then observed, however, that this provision was not the only one applicable. It noted that Education Law §216-a(4)(d) provided:

> The following adjusting provisions shall apply in the application of the not-for-profit corporation law under this section:
>
> …
>
> (13) The opening clause of paragraph (a) of section eleven hundred two shall read: "With the consent of the regents of the university of the state of New York, a petition for the judicial dissolution of a corporation may be presented:"

Accordingly, the *Friends* court explained, inasmuch as the Friends proceeding was a judicial dissolution, Article 11 of the N-PCL thus also was applicable. As provided in N-PCL 1115, subject to other Article 11 provisions, certain provisions of Article 10 (relating to non-judicial dissolutions) applied. In particular, N-PCL 1115(a) incorporated N-PCL 1008. N-PCL 1008 in turn provided, in relevant part, that the court overseeing a judicial dissolution:

> may make all such orders as it may deem proper in all matters in connection with the dissolution … of the corporation, and in particular, and without limiting the generality of the foregoing, in respect of the following:
>
> …
>
> (9) The payment, satisfaction or compromise of claims against the corporation, the retention of assets for such purpose, and the determination of the adequacy of provisions made for payment of the liabilities of the corporation.
>
> …
>
> (15) Where assets were received and held by the corporation either for a purpose specified as Type B in paragraph (b) of section 201 (Purposes), or were legally required to be used for a particular purpose, the distribution of such assets to one or more [entities] engaged in activities substantially similar to those of the dissolved corporation.[12]

Similarly, the *Friends* court continued, N-PCL 1109, describing the court's discretion with respect to the final order of dissolution, provided that:

> If the judgment or final order shall provide for a dissolution of the corporation, the court may, in its discretion, provide therein for the distribution of the property of the corporation to those entitled thereto according to their respective rights. *Any property of the corporation described in subparagraph one of paragraph (c) of section 1002-a (Carrying out the plan of dissolution and distribution of assets) shall be distributed in accordance with that section* (emphasis added).[13]

The appellate court ruled that the distinction between subparagraphs 9 and 15 of 1008(a) made clear that the sale of assets to pay debts was not a "distribution." This conclusion was further buttressed by N-PCL 1002-a(c)(1), it stated. That section also distinguished between payment of liabilities and distributions, which occurred only after payment of creditors:

> Prior to filing the certificate of dissolution with the department of state, a corporation, as applicable, shall:
>
> (c) Distribute the assets of the corporation that remain after paying or adequately providing for the payment of its liabilities, in the following manner:
>
> (1) assets received and held by the corporation either for a purpose specified as Type B in paragraph (b) of section 201 (Purposes) or which are legally required to be used for a particular purpose, shall be distributed to one or more [entities] engaged in activities substantially similar to those of the dissolved corporation pursuant to the plan of dissolution and distribution or, if applicable, as ordered by the court to which such plan is submitted for approval under section 1002 (Authorization of plan). Any disposition of assets contained in a will or other instrument, in trust or otherwise, made before or after the dissolution, to or for the benefit of any corporation so dissolved shall inure to or for the benefit of the corporation or organization acquiring such assets of the dissolved corporation as provided in this section, and so far as is necessary for that purpose the corporation or organization acquiring such disposition shall be deemed a successor to the dissolved corporation with respect to such assets; provided, however, that such disposition shall be devoted by the acquiring corporation or organization to the purposes intended by the testator, donor or grantor.[14]

The appellate court explained that all of the statutes it had reviewed established that, in the operation of an NFP, assets held for a specific use may not be used for another purpose,[15] and, upon dissolution, after liabilities were paid, distribution of such assets that "remain" had to be made under the *quasi cy pres* doctrine to an entity "engaged in activities substantially similar to those of the dissolved corporation."[16] Of course, the

appellate court added, a court could order the sale or use of unrestricted assets to pay creditors.

THE ISSUE RESOLVED

The tension in *Friends*, the appellate court continued, was between "two legitimate interests" — the rights of creditors and the limitations imposed by donors under which the NFP held certain assets. It noted that both sides warned of "dire consequences" flowing from the rejection of their position. The appellants warned of a "chilling effect" on charitable giving if prospective donors could not be confident that their charitable purposes would be honored; various parties on the other side warned of the difficulty struggling charities might have in obtaining credit during times of economic stress if prospective creditors could not be certain that they would be repaid out of the valuable assets of the NFP.

The appellate court then reached its major conclusion: It held that New York's "long-standing policy honoring donors' restrictions on the use of the property they donate" had "greater weight than the claims of creditors." To hold otherwise, it reasoned, would be "to sanction a gap in the protection of the donors' expressed limitations." The appellate court observed that the New York State Legislature had provided that NFPs must comply with the limitations imposed by donors. Moreover, under N-PCL 513(b), funds relating to such assets must be kept in separate accounts and reports must be made annually to members or the governing board regarding such assets. Further, under 8 NYCRR 3.27(6)(iv), items in collections could not be used as collateral for loans. "Even in dissolution, the limitations on the use of such assets is required to be honored," the appellate court determined, and "not necessarily" to the lesser extent of *quasi cy pres*.

In the appellate court's view, the last sentence of N-PCL 1002-a(c)(1) extended the donors' limitations on use of an asset to the receiving entity. "These strong statutory enactments convince us that the Legislature has not expressed an intention, by mere omission, to temporarily render inoperative the limitations during the period of dissolution only to revive them after debts are paid."[17] Rather, it has emphasized the view that the public places greater importance on the limitations on the use of the asset than on

which entity actually held it.

The appellate court also stated that, although it in no way wished "to minimize the importance of financial losses suffered by creditors," some of which were employees of NFPs, it recognized that, "once lost, items in a museum collection, or the items or programs that a limited fund supports, may be lost to the public forever if they may be used to pay debts during liquidation." When the items had been donated without limitation, that might be the unfortunate result. But where there is a limitation on the use of the asset, "that limitation must be honored in the operation and dissolution of the NFP," the appellate court held.

In that respect, it noted that, in this proceeding, it was not only the Levine Collection that might be lost to the public, but also the cultural and historical benefit of the Old Bethpage Village Restoration. The Campbell Fund, as a dedicated fund, was not subject to the competing demands on government funds, but Nassau, however well intentioned, could not guarantee its support of the Old Bethpage Village Restoration if the Campbell Fund were extinguished.

The appellate court said that there was "no dispute" in this case that the Campbell Fund was an asset held for a specific purpose. In accordance with the foregoing analysis, therefore, it held that the Campbell Fund "may not be liquidated in order to pay the claims of creditors. To do so would be to extinguish the purpose behind the gift."

THE LEVINE COLLECTION

The appellate court's analysis with respect to the Levine Collection, which also undisputedly was an asset held for a particular purpose, was somewhat different. The appellate court stated that, with the dissolution of Friends, the trial court had to decide what to do with the Levine Collection. The appellate court noted that the appellants contended that it could not be sold at all, but instead had to be distributed consistent with the doctrine of *quasi cy pres*. The appellate court said that it did not see a sale as completely proscribed by that doctrine, however. If the purpose behind the donation of a charitable asset may be maintained even with a sale to satisfy, or partially satisfy, the claims of creditors, nothing in the

law required that the asset be distributed without charge. It then held with respect to the Levine Collection that, consistent with the doctrine of *quasi cy pres*, the trial court

> may provide for its sale, as a single collection, to an entity that is engaged in activities substantially similar to those of Friends, and a condition of the sale shall be that the entity acquiring the Levine collection, either directly or indirectly, agree to be deemed a successor to Friends with respect to the Levine Collection and to be bound by those conditions of the Loan and Gift Agreement under which Friends acquired it that the court may find to still be practicable.

It may be that, with such a restriction, the proceeds from the sale may be less than that of an unrestricted sale. Nevertheless, the policy behind the protection of restricted assets was "strong enough to require such a result," the appellate court stated.

Interestingly, the appellate court said that even if it had found that there was no limitation under the law on the use of the Campbell Fund and the Levine Collection to satisfy the claims of creditors, it would nonetheless have reversed the trial court's order on the ground that approval of the settlement was an "improvident exercise of discretion." As the appellate court noted, there had yet been no determination of the true extent of the assets of Friends,[18] owing to what the appellate court characterized as "the lack of stringent record keeping over the years by both Friends and Nassau, leading to the selection of perhaps the most valuable assets of Friends, both of which were given for limited uses." Before the limited-use requirements relating to those assets could be extinguished to satisfy the claims of the creditors, a full accounting of Friends' assets must be made, it ruled.

CONCLUSION

The *Friends* decision sets forth important rules regarding the use of an art museum's collection to pay creditors in the event of the museum's dissolution. This ruling goes a long way to protecting collections, once established. It does not help, however, with the need that these kinds of

not-for-profit entities have — as do all businesses — to pay ongoing debts. Those obligations will have to be met, as they long have been, by donations and contributions intended for those purposes. It may be that only an uptick in the economy will allow the country to avoid the destruction of these institutions in the future.

NOTES

[1] *See, e.g.,* Robin Pogrebin, "Museum Sells Pieces of Its Past, Reviving a Debate," available at http://www.nytimes.com/2010/12/06/arts/design/06sales.html?scp=1&sq=museum%20sale%20of%20art&st=cse.

[2] No. 19423/05 (N.Y. App. Div. 2d Dep't Nov. 16, 2010).

[3] Ownership of many of the thousands of items in Nassau's possession and obtained for Nassau by Friends was disputed.

[4] Friends had asserted in its amended plan that the Campbell Fund contained $276,636.38, and the Levine Collection had been appraised in the Spring of 2006 at $409,645.

[5] N-PCL 513(b).

[6] N-PCL 513(b).

[7] 281 N.Y. 115 (1939).

[8] *Id*. at 117.

[9] The Court, in so holding, rejected the assertion that such limitations were merely "precatory" and thus not binding (281 N.Y. at 128 [Hubbs, J., dissenting]).

[10] Education Law §220(1).

[11] Education Law §220(4) (emphasis added).

[12] Under Education Law §216-a, "[e]very corporation to which the not-for-profit corporation law is made applicable by this section, is a type B corporation under all applicable provisions of that law." Friends was, therefore, a type B corporation.

[13] After the special proceeding had been commenced in *Friends*, the New York Legislature amended the N-PCL (*see* L 2005, ch 26). None of the parties maintained that the changes affected the resolution of the proceeding, so the appellate court used the post-amendment version of the N-PCL in its decision.

[14] N-PCL §1002-a.

[15] *See* N-PCL 513.

[16] *See* N-PCL 1002-a(c)(1). "Cy pres" means, literally, "as near as" (Black's Law Dictionary (9th ed 2009)). New York's version of the doctrine is less strict than the original common law doctrine ("as near as possible"). As originally made applicable to a trial court's power over charitable corporations, New York's version has been stated as follows: "[i]f circumstances have so changed that a literal compliance with the terms of the gift is impracticable, then [the trial court] may order the gift to be administered so as best to accomplish its purpose." *Sherman v. Richmond Hose Co*., 230 N.Y. 462, 472-73 (1923). That standard has been relaxed in the N-PCL section relating to distribution of limited-purpose assets of a dissolving NFP to require merely that such assets "be distributed to [entities] engaged in activities substantially similar to those of the dissolved corporation." N-PCL 1002-a[c][1]. In *Matter of Multiple Sclerosis Serv. Org. of N.Y. (New York City Ch. of Natl. Multiple Sclerosis Socy.)*, 68 N.Y.2d 32, 35 (1986), the Court of Appeals provided various factors for a court to consider when applying this *quasi cy pres* doctrine.

[17] The appellate court acknowledged that the New York Legislature could have made the limitation on sale of assets to pay creditors explicit, but that it had not done so in this area, as it had in others; *see, e.g*., N-PCL 1408, providing that historical societies may "receive donations of articles of historic interest on the condition that in case of its dissolution or inability to pay its debts otherwise than from its effects, such articles shall revert to the donors or their heirs."

[18] *See* Education Law §220(1); N-PCL 1104(a).