

CHURCH & THE LAW UPDATE - No. 6

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Updating Churches and Charities on recent legal developments and risk management considerations.

1. INTRODUCTION

This is the sixth issue of Church & the Law Update. It is intended to provide an update for churches and charities on current legal developments as well as providing recommendations on matters of legal risk management where appropriate. The Update is prepared for distribution as a service to churches and charities and is published approximately three to four times a year as legal developments occur.

This issue of the Church & the Law Update includes a commentary on establishing lifestyle policy statements for churches, as well as a summary of lessons to be learned from the recent New Era scandal in the United States.

2. DATE FOR THE 1996 ANNUAL CHURCH AND THE LAW SEMINAR

The 1996 Annual Church & the Law Seminar will be held in Toronto on Wednesday, February 7th, 1996. More details of the topics and location will be given in future issues of the Church & the Law Update.

3. BOOK AVAILABLE ON INCORPORATION OF CHURCHES

A new book entitled "To Be or Not To Be, Incorporation of Churches in Ontario" by Terrance S. Carter, B.A., LL.B., is available from the Canadian Council of Christian Charities on a cost recovery basis of \$15.00. The precedent that is included in the book of a model By-Law for an incorporated church is based on a federal incorporation and therefore may be of interest to churches in other provinces other than Ontario, particularly those churches that are in the process of incorporating or revising their existing church constitutions or by-laws.

4. THE IMPORTANCE OF LIFESTYLE POLICY STATEMENTS FOR CHURCHES

The Globe and Mail carried an article on May 27th, 1995 entitled "The Ties that Bind - More Churches Blessing Gay Unions". The article stated that a handful of congregations had recently passed resolutions permitting their ministers to perform "holy union" services between individuals of the same sex.

The importance of the article from a legal context is not the fact that some congregations are blessing unions between individuals of the same sex, but rather the need for churches that do not condone such an interpretation of scripture to adopt lifestyle policy statements that reflect their understanding of biblical principles to avoid future controversy or possibly even a legal challenge concerning what the official position of a church is in such matters.

A policy on lifestyle considerations must be carefully drafted to avoid ambiguity. Some policy statements in this regard are so vague as to cause more confusion than having no lifestyle policy statement at all.

A properly drafted policy statement on lifestyle considerations should have clear scripture references so that the statement can be

justified as being a bona fide expression of faith to offset criticism of possible discrimination when the policy statement is implemented.

Once a precisely worded policy statement has been prepared, it needs to be circulated and voted upon by the congregation and made a part of the church constitution. The means by which a policy statement can be incorporated by reference into a church constitution is discussed in more detail in the book on Incorporation of Churches referred to above.

Finally, only lifestyle considerations that are fundamental to a churches understanding of the Christian faith should be included in a lifestyle policy statement, since policy statements should be diligently implemented and may form the basis of church discipline of members who vary from its standards. As a result, churches should shy away from etching in constitutional stone every "do and don't" involved with the Christian faith and instead leave policy statements on lifestyle considerations to those matters that are most important to a churches understanding of practical application of biblical principals.

5. "NEW ERA" SCANDAL IN U.S. HAS LESSONS FOR CANADIAN CHARITIES

A. Introduction

The Wall Street Journal recently ran a series of articles on a charity scam involving some of the largest charities in the United States, including a number of prominent Christian charities. The first reaction of Canadians in learning about this scandal may be to dismiss it as simply another example of extremism of our neighbours to the south, similar to the Jimmy Baker scandal a few years ago, which one assumes could never happen in the more conservative and constrained environment of our Canadian culture. However, there are enough similarities in some of the basic errors surrounding the U.S. scandal that occur north of 49th parallel to justify examining the scandal to determine what lessons can be learned to avoid similar problems in this Country.

B. Summary of Relevant Facts

The Wall Street Journal reported that the scandal centered around Mr. John G. Bennett, Jr., who was the chief executive officer of an organization called the Foundation for New Era Philanthropy, a charity based in Radnor, Pennsylvania, that was started in 1989. By the time the scandal broke in May of this year, New Era had attracted contributions from charities and individuals of approximately one quarter of a billion dollars in U.S. funds based upon the representations of Bennett, a highly respected figure in the Philadelphia area who had a high profile as a philanthropist in Christian circles, due in part to the prayer breakfasts that he often organized.

The scandal, in essence, constituted what is commonly called a "Ponzi Scheme", where payments are made by one wave of investors that are then used to pay back an earlier wave of investors with very high returns so that additional investors with new monies will continue to be attracted.

In the early 1990's, Bennett's New Era Foundation started to attract a great deal of attention, notwithstanding that it was not registered with the Internal Revenue Service as a foundation. The attention that Bennett attracted was due to his claim that the New Era Foundation would double contributions made by charities and individuals to New Era within a period of six months as a result of undisclosed donors who wished to remain anonymous and were prepared to match the gifts entrusted to the New Era Foundation by distributing matching gifts worth millions of dollars. Apparently, these wealthy donors were too busy to find worthy charities on their own to benefit from their excessive monies.

Why charities were required to contribute monies to New Era for six months was never adequately explained by Bennett, except that it was claimed to be a non-negotiable requirement of the anonymous donors. Most matching gift programs do not require the charity to deposit funds with the granting agency. Instead New Era could have simply distributed the millions of dollars that it purported to have available to it upon independent confirmation that the charity or individual in question had raised the monies against which the matching grant would apply or in the case of individuals, a gift had been made to the charity approved for the matching grant.

The scam was initially given credibility when a minister of a Baptist Church in Pennsylvania who was the driving force behind a small struggling seminary received a matching grant in return for a five hundred thousand dollar (\$500,000.00) contribution to the New Era Foundation. Not surprisingly, word spread quickly within the Christian community as well as within the secular philanthropic circles that the New Era Foundation and Bennett were true to their word in being able to produce a 100% return on contributions made to the Foundation.

Before long, New Era was attracting large contributions from many prominent Christian organizations in the United States, such as Wheaton College, Compassion International, Gordon College, Intervarsity Christian Fellowship U.S., Moody Bible Institute, Missionary Aviation Fellowship, the Salvation Army, and Youth for Christ, just to mention a few.

In addition, New Era Foundation also received contributions in the millions of dollars from a number of high profile U.S. philanthropists who were willing to make sizeable contributions to the New Era Foundation so that they could double their normal charitable giving. Included in the list of prominent philanthropists were Laurance S. Rockefeller, the brother of David Rockefeller, William E. Simon, former Treasury Secretary of the United States, Pat Boone, John C. Whitehead, the former Chairman of Goldman Sachs & Co., a large wall street brokerage firm in New York, and John Pepper, President of Proctor & Gamble. However, the single largest contributor to the foundation and as such its largest creditor when the scheme collapsed was the first contributor to the foundation, Reverend Glenn Blossom of Dresher, Pennsylvania, who was shown to be a creditor of New Era for the incredible amount of twenty-seven and one-half million dollars (\$27,500,000.00).

While the New Era scheme was initially being investigated, a number of individuals were interviewed who were willing to defend the matching gift program operated by New Era. The Wall Street Journal in May of this year contained a number of quotations that in hindsight are revealing. One of them was by the auditor for New Era Foundation who stated that:

"There is so much widespread cynicism in the world that people cannot accept that there is a wealthy philanthropist who has a net worth in the hundreds of millions who is willing to give away substantial amounts and get no credit for it."

Another quotation was that of John C. Whitehead, the former Chairman of Goldman Sachs & Co., who called Mr. Bennett "a visionary" and that New Era was "on the cutting edge of philanthropy". The former U.S. Deputy Secretary of State is also quoted as saying before the scandal broke, "We are not naive doops, I don't think".

The most recent annual report from New Era contained a telling statement concerning how Bennett described what New Era was doing:

"We do not fall within the general accepted model of an organization that provides financial support in a typical fashion. We consider ourselves philanthropic entrepreneurs and venture capitalists in philanthropy ... Much of what we are doing has no precedent."

Notwithstanding Bennett's claim that there was no precedent for what New Era was doing, Bennett was in fact following the example established by Charles Ponzi of Boston back in 1919, when Ponzi defrauded individuals by using current contributions from investors to pay off obligations to past investors at high returns. However, Charles Ponzi would have been envious of Bennett's scheme that promised one hundred percent returns to investors after only six months.

Bennett was able to maintain credibility in meeting the obligations of the matching gift programs by using not only new monies received from contributors but also by arranging a fifty-two million dollar (\$52,000,000.00) loan with Prudential Securities based upon deposits of approximately seventy-three million dollars (\$73,000,000.00). It is estimated that New Era at the time of its collapse in May of this year had received in excess of two hundred and fifty million dollars (\$250,000,000.00) in contributions, with liabilities arising out of the promises to double those monies of in excess of five hundred million dollars (\$500,000,000.00), but with only eighty million dollars (\$80,000,000.00) in assets. As such, there was a shortfall of approximately one hundred and seventy million dollars (\$170,000,000.00), not to mention an even larger liability if the promise to double the contributions are taken into account.

Although Bennett claimed that he did not receive a salary from New Era, he did see fit to have New Era Foundation pay consulting fees to various companies that he controlled in the amount of approximately 4.5 million dollars. Needless to say, contributors to the Foundation had no idea that Bennett was indirectly receiving this amount of money from New Era.

For anyone who wanted to investigate the validity of the matching program offered by New Era, they were a number of warning signs that were readily apparent. For instance:

1. New Era issued receipts for monies received by categorizing those monies as gifts to New Era, whereas individuals and charities that contributed considered those monies to be an investment that would double within a period of six months.
 2. The contributions made to New Era were held in a "brokerage account", to which Bennett had access, instead of depositing the
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monies into an "escrow account", i.e. a trust account that would have prevented both Bennett and New Era from having access to those funds.

3. New Era was not registered as a foundation with the IRS, even though its name implied that it was a foundation.
4. New Era issued financial statements based upon an accounting opinion that was only a review as opposed to a full audit.
5. There were indications in the last year that New Era was running short of the cash needed to double the investments received when New Era began to encourage charities that had given in the past to contribute their entire endowment funds even though those endowment funds were impressed with donor designated restrictions on the use of those monies.

Notwithstanding these obvious warning signs, a large number of charities, including a "who's who" of Christian charitable organizations, lined up to make contributions to New Era in the expectation that their monies would be doubled within six months. The Wall Street Journal quoted an accountant who had several clients who deposited money with New Era as saying: "It's amazing. Anyone who is significant in the evangelical community has been involved in this thing." This involvement was based upon the trust that Bennett had established as an evangelical Christian as well as by word of mouth testimony amongst Christian leaders concerning the paybacks that they had received on his promise to double their contributions after a period of six months. As such, many evangelical organizations encouraged other Christian institutions to become involved in the matching gift program of New Era.

The reputation of Bennett and New Era was enhanced by Bennett's association with Sir John Templeton, the founder of the popular Templeton Mutual Funds. After Sir John Templeton was introduced to Bennett in 1990, he asked Bennett to serve as a director and/or trustee of twenty-four mutual funds. In addition, the names of both Sir John Templeton and his son, Dr. Templeton, appeared on brochures of New Era under the heading of "client references", the Wall Street Journal reported. In addition, New Era established a Templeton Institute Prize for Excellence, although it was apparently never awarded.

Not only were leading political and Christian leaders fooled by the matching gift program, the Attorney General for Pennsylvania in reviewing the operation of New Era gave the institution a "clean bill of health" when his office was unable to find any dissatisfied donors. What the Attorney General missed in his investigation was a review of where the monies were coming from that were being used to double the contributions that had been made by earlier contributors within the last six months. As long as contributions were being doubled, it was no wonder that no donors could be found to complain about the matching gift program.

The unravelling of the New Era scam began as far back as July of 1993, but did not culminate until May of 1995. This unravelling process started in 1993 when Albert Meyer, an accountant who taught at a Christian college that had given monies to New Era, became suspicious when he found in excess of two hundred and fifty thousand dollars (\$250,000.00) had been transferred from the college to New Era.

When Meyer took his concerns to the college administrators, he was told "it's tough raising funds, and they didn't need my meddling". He then contacted institutions that had invested money with New Era, including Wheaton College in Illinois and Moody Bible Institute in Chicago. After those institutions ignored his warnings, he then wrote to the Internal Revenue Service and asked that they investigate. Meyer also called Bennett directly and found that Bennett was very amicable. Time Magazine quotes Meyer as saying, "at the end of our conversation when I put down the phone, I actually liked the guy". Just two weeks before the scam fell apart in May of this year, the administrator of the college that Meyer taught at assured his community of supporters of the Board's business savvy and warned faculty members, of which Meyer was one, that a "healthy scepticism was commendable, but a crusading zeal was often counterproductive". However, after the scandal broke, Meyer received a letter from the college which said in part "I believe you did something heroic, you followed your professional instincts when many of us believed you to be wrong".

A letter from Meyer to the SEC in April, 1995 prompted the SEC to commence an investigation of New Era which ultimately led to its collapse. As a result of the SEC investigation Prudential Securities found that New Era had borrowed 44.9 million on margin and failed to repay on demand. On Thursday, May 11th, 1995, Prudential Securities commenced an action against New Era and its chief executive officer to recover the funds. On Saturday, May 13th, 1995, Bennett finally admitted to his staff that there were in fact no mysterious benefactors who were supplying matching monies. Instead, the monies were coming from new contributors together with monies that had been borrowed on the strength of the contributions that he had already received.

As a result of Bennett's startling admission, New Era filed for protection under section 11 of the U.S. Bankruptcy Code, and after it was

clear that there was no hope of restructuring New Era, the matter was moved into liquidation proceedings under the same Act. The U.S. Security and Exchange Commission has now sued Bennett and his Foundation for New Era Philanthropy accusing Bennett of engaging in a massive "fraud that cheated hundreds of charitable institutions as well as some of the nations wealthiest financiers".

As news of the scandal travelled through the U.S. philanthropic and Christian community in May of this year, one of Bennett's chief supporters, John Whitehead, who had given over a million dollars (\$1,000,000.00) to New Era is quoted in the Wall Street Journal as having said, " I can't believe it, I'm normally very sceptical about these kinds of things and it's hard for me to believe that I was played for a sucker".

C. Lessons to be Learned in Canada

As Canadians, we are apt to dismiss what has taken place in the United States with the New Era scam as having little relevancy to charities in this Country. This is clearly not the case. Canadian charities that have close affiliation to their American counterpart will need to assure themselves that monies that were to be invested by their U.S. counterpart pursuant to joint ministry arrangements were not invested in the New Era program. If joint venture monies were invested in this manner, Canadian charities should speak with their legal counsel concerning the ramifications in Canada of Canadian charitable monies having been used in this way and possible liability to recover monies that may have been lost through the New Era matching gift program.

Even for those Canadian charities that have not been involved directly or indirectly with the New Era scandal, there is still a number of practical lessons from a legal context that can be learned and applied in Canada. A summary of some of the more important lessons in this regard are set out below:

1. The New Era scam was presented as a matching gift program, but in fact required the monies be given to New Era so that it would become part of its investment portfolio instead of having those monies held in trust pursuant to an escrow account to ensure that the monies would be kept separate and apart from the operating funds of New Era. If individuals and charities that gave to New Era did nothing more than simply read the receipts that were issued to them, they would have seen that New Era was treating those monies as gifts instead of trust funds in violation of how the donors assumed that their monies would be held.
 2. Since charities that gave to New Era assumed that they would receive back the initial contribution together with a 100% matching gift, the payments to New Era constituted a form of high risk investment that in hindsight make volatile "derivatives" investments on the stock market pale in comparison. In Canada, a high risk investment like the matching gift program offered by New Era could not be justified as a qualified investment under the *Trustee Act*. Nor could it be justified pursuant to the common law requirement that directors of charities act in a prudent manner in fully investigating a prospective investment before proceeding. Failure to restrict investments to carefully selected and conservative investments could leave directors in Canada personally liable for improvident investment decisions of the kind involved with the New Era matching gift program.
 3. An obvious but important lesson from the New Era scandal is that if a promise of return on an investment or tax advantage looks too good to be true, then it probably is. The bona fide desire to advance the charitable objectives of a charity cannot justify using charitable monies in ways that are either risky or questionable. Put simply, risk is not compatible with charitable objectives.
 4. The New Era matching gift program was touted as being on the "cutting edge of philanthropy" with much of what was done as "having no precedent". Charitable programs that are touted as not having any precedent and are claimed to be on the "cutting edge" should clearly not be utilized by a charity or church without the charity first obtaining a written opinion from a lawyer confirming that the program in question is legitimate. It may be necessary to provide the lawyers with the comments of a chartered accountant with respect to any financial information provided in connection with such a program. By doing so, if the program being offered turns out to be either invalid or results in loss of monies for a charity, then the charity in question can rely upon the professional opinion that was obtained to help establish a defense of due diligence in the event that a claim is subsequently directed at the charity or at its board of directors based on an allegation of negligence in making the investment decision.
 5. Beware of the "follow the leader" syndrome. Too often, a Christian charity and/or church will adopt a program, such as a stewardship program that promises to have significant benefits for the charity, based solely upon the fact that another Christian charity is using it without the charity first carrying out their own due diligence investigation of the program. An investigation in this regard should include
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consulting with charitable services like the Canadian Council of Christian Charities as well as contacting a number of other charities to determine whether or not they are using the program.

In addition, charities should obtain their own legal or accounting opinion. What often happens, however, is that one charity will rely upon the legal or accounting advice obtained by another charity. Even if that other charity did obtain their own legal or accounting opinion, such opinion will not necessarily mean that another charity can rely upon the opinion obtained in the event that the program in question turns out to be invalid.

What in fact often happens is that no legal or accounting opinion was ever obtained to justify the validity of a particular program in the first place. Instead, there are only "rumours" of some lawyer or accountant who is said to have given a "blessing" to the program in question when no written opinion was ever obtained. As such, it is essential that each charity carry out its own due diligence investigation by ensuring that they obtain their own legal or accounting opinion.

6. New Era called itself the "*Foundation* for New Era Philanthropy". Despite its name, New Era did not meet the accepted requirements for a U.S. foundation, i.e. an organization with an endowment that invests its earnings so that it can make gifts to other charities. In Canada, a foundation does not have to have an endowment, nor is a foundation prohibited from carrying on charitable activities itself. However, under section 149.1(1) of the *Income Tax Act*, a charitable foundation, whether it be a public or private foundation, is defined as meaning a corporation or trust that is constituted and operated exclusively for *charitable purposes*, which in turn is defined as including the disbursement of funds to qualified donees, i.e. other registered charities. As such, even in Canada, the use of the term "foundation" is normally intended to convey the fact that the charity will not be primarily carrying on charitable activities itself, but rather will be transferring monies to active charitable organizations which will in turn carry on charitable activities.

A number of charities established over the last few decades have used the word "foundation" in their name as a misnomer. However, new charities that have been established recently should be careful not to use the word "foundation" in their name when the charity is intending to primarily carry on charitable activities itself as opposed to funding other charities. Although there is technically nothing wrong with including the word "foundation" in the name of a charity, it does give the impression that the charity has a degree of stability through the assumed existence of an established endowment, which is often not in place. As a result, individuals or charities that deal with organizations that call themselves "foundations" should not necessarily assume that such an organization is either a public or private foundation. Inquiries should be made of the organization to find out exactly what it is, i.e. is it a foundation primarily established to fund other charities or is it intending to primarily carry on charitable activities itself.

7. In the New Era scandal, the Attorney General of Pennsylvania investigated the activities of New Era and gave it a "clean bill of health" after he was unable to find any dissatisfied donors, notwithstanding that shortly thereafter New Era was found to have perpetrated a fraud on a colossal scale. The lesson to be learned from the New Era scam is that an audit by a government authority, whether it be Revenue Canada or the Public Guardian and Trustee of Ontario, does not necessarily mean that everything that a charity does is legitimate. What is required instead is a specific ruling from Revenue Canada or from a qualified professional confirming that the program being offered by the charity is in compliance with all applicable legislation.
 8. Bennett was able to promote the matching gift program through New Era by eliciting the support of or using the names of various prominent philanthropists and Christian leaders, including at times the names of individuals like Sir John Templeton. The lesson to be learned from this type of association is that a charity which has to rely upon "name dropping" from either prominent individuals or other charities to elicit credibility for its program should be viewed with suspicion. A program being offered by a charity should either stand or fall on its own merit without having to obtain credibility by relying upon outside referrals.
 9. A number of Christian organizations not only invested surplus funds in the New Era matching gift program, but also transferred large portions of their endowment funds (and in some cases even one hundred percent [100%] of their endowment funds) to the New Era Foundation. Since endowment funds constitute donor restricted trust funds that can only be used for the specific purposes set out by the donor in making the gift, the duty upon the directors of those charities to ensure that the endowment monies are invested with caution is even greater than the normally high duty to carefully invest monies of a charity in a prudent manner. As a result, the directors of the charities who contributed or invested endowment funds in the New Era scam could, in Canada at least and possibly even in the United States, find themselves personally liable to repay the lost endowment funds.
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10 A number of auditors and accountants who advised charities that invested in New Era raised questions about the matching gift program being offered. The boards of directors of those charities either ignored these warnings or attempted to downplay them out of fear of appearing to "bite the hand that was feeding them". Boards of charities however should actively encourage their professional advisors and in-house accountants to diligently raise questions and bring concerns to the board without fear of reprisal or rejection. Auditors, accountants and lawyers who act on behalf of charities should be relied upon to provide a sober reflection on activities of a charities. In the New Era scandal, many leading Christian charity in the United States could have avoided losses of tens of millions of dollars if the advice offered by their auditors and other professionals had been heeded.

11 Although Bennett touted the fact that he did not receive a salary from the New Era Foundation, he did manage to divert approximately 4.5 million dollars of contributors monies from New Era to various companies that he controlled by categorizing them as consulting fees. While there is nothing wrong with a charity paying for consulting fees, it has to be in relation to a legitimate expense so that the charity receives value in return for the payment made. What happened in the New Era Foundation and what charities in Canada should be diligent to ensure does not happen here is the categorization of improper payments by a charity under the catch all guise of a consulting fee in situations where a payment made directly to that individual in the same amount could never be justified as a salary expense.

As such, due diligent requirements in investigating a charity or an investment opportunity should involve questioning whether there are consulting fees that the charity is paying, and if so, why are payments being made as a consulting fee as opposed to the payment of a salary, are the consulting fees reasonable, who are the shareholders and directors of the company to which the consulting fees are paid, and do such payments constitute a direct or indirect conflict of interest for any members of the board of directors, officers, or employees of the charity that is paying the consulting fee in question?

D. Conclusion

The New Era scandal has shaken the very roots of the philanthropic community in the United States and in particular the boards of many prominent Christian charities. The ramifications of the scandal will have profound consequences on Christian organizations for years to come. What has happened in the United States should act as a "wake up call" for Canadian Christian charities to become more diligent in reviewing promises of "quick return" investments or a "too good to be true" philanthropic stewardship vehicles before deciding to proceed.

The law in Canada requires directors of charities to be prudent in their dealings with the assets of their charity in a manner similar to how an executor of an estate with infant beneficiaries would carefully watch over the investments that he or she had been placed in charge of. This requires that boards of charities be vigilant in exercising a due diligence investigation of any new investment opportunity or stewardship vehicle. It is not sufficient to simply "follow the leader" and rely upon what other organizations are doing, even charities that themselves are credible and well respected. The law demands more and our faith as Christians requires no less. At times, public scrutiny can help Christian charities to pause and reflect upon their duties and obligations. In this regard, the New Era scandal, as disturbing as it is, will have at least served a useful secondary purpose.

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