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Legal Issues Related to Unfulfilled Charitable Pledges

In today's challenging economic environment, where large amounts of wealth are "disappearing" overnight, the fulfillment of charitable pledges can no longer be taken for granted. Charities, donors, professional fund raisers and third parties such as banks, landlords, and suppliers are increasingly asking whether pledged funds will in fact materialize, and what to do if they do not.

What is a Charitable Pledge? As a legal matter, a charitable pledge is a contract between a donor and a charity in which the donor promises to make a contribution in the future. Pledges may be oral or in writing. According to the Financial Accounting Standards Board (FASB), charities are required to record enforceable pledges as assets when they are made, just like any other debt obligation. If a pledge is not fulfilled, the charity must write off the unpaid amount of the pledge.

When is a Pledge *Legally* Binding and Enforceable? Under traditional contract law principles, a charitable pledge is enforceable if it meets the requirements for a legally binding contract. There must be an agreement between the donor and the charity -- in effect, the donor must promise to make a gift and the charity must promise to accept it. The terms of the agreement must be clear and all conditions specified. There must be "consideration" given in exchange for the pledge, which essentially means that the charity must agree to do something (or not do something) in exchange for the promised donation.

Alternatively, courts will enforce a pledge if the charity has suffered some detriment by taking action in reasonable reliance of the pledge, even though such detriment was not requested as consideration. This legal principle is known as "promissory estoppel" or "detrimental reliance." Actions that constitute detrimental reliance include soliciting other donors based on the pledge, incurring costs, entering into contracts, or borrowing money based on the expectation that the donor's promise will be kept. This principle is currently the law in roughly 30 states.

There are certain defenses that can be raised to avoid enforcement of oral agreements, including if the agreement is not one that is capable of being performed within one year from the time of the agreement. This defense against enforcement is called a "statute of frauds" defense. However, a party may be barred from raising the statute of frauds as a

defense if the charity has relied on the promise to its detriment or the donor has performed part of the agreement (i.e., made payments).

While some state courts have not been willing to enforce a pledge unless the traditional contract law requirement of consideration or detrimental reliance exists, there has been a modern trend to do away with that requirement where charitable pledges are concerned. The Second Restatement of Contracts (one of the primary legal authorities on the legal issues affecting contracts) has taken this view, stating that pledges are legally binding whether or not the charity has taken action in reliance on the pledge, and that as a matter of public policy, injustice can be avoided only by enforcement of the promise. An Ohio court held that a charitable pledge is equivalent to a promissory note valid on its face and is therefore enforceable against the person making the pledge without any consideration. A few other courts have stated that no consideration is necessary and a pledge is legally binding once it has been made. New York courts have suggested getting rid of the consideration or detrimental reliance requirement in the context of enforcing charitable pledges, but have not yet officially taken such a step.

If the donor (or promisor) dies without fulfilling the pledge, the pledge is also enforceable against the donor's estate. Under normal probate and estate administration rules, the charity must assert a claim against the estate in order to have standing to participate as a beneficiary in the probate or estate proceedings.

Courts generally favor charities in these disputes, and will enforce a pledge even if the donor claims some technical defect in the charity's claim. For example, in a 1977 New York case, the court ruled that, when considering whether or not to uphold pledges to charity, "as a matter of public policy," courts should "seek to resolve doubtful questions so as to avoid their repudiation." Under this judicial philosophy, it is unlikely that a donor will be able to resist enforcement merely because his or her financial circumstances have deteriorated, especially if the charity has acted reasonably in reliance on the pledge.

In an extreme case, where it is impossible for the donor to make good on a gift (if for example they have lost substantially all of their wealth), courts may elect to modify or rescind the pledge agreement. In these cases, the donor will have declared bankruptcy or will be forced to do so by the charity's claim. It is worth noting that a legally binding pledge can be asserted as a claim in a bankruptcy proceeding, provided that it meets the test for a valid contract in that state. Massachusetts, for example, has specifically recognized this right for bankruptcies filed by state residents.

Is a Charity Ever Required to Sue a Donor for an Unfulfilled Pledge? Whether or not a charity is obligated to sue a donor will depend upon the facts and circumstances of each situation. There is no general, affirmative obligation to sue a donor. However, as discussed below, in an extreme case such as where the donor is capable of fulfilling the pledge but simply refuses to do so and the consequences to the charity are significant, the fiduciary duties of the charity's board may require the commencement of litigation if no other reasonable alternative exists. The charity's board of directors should make the

decision after carefully reviewing all relevant information. In deciding what to do, the board should keep the following considerations in mind:

First, the charity's directors owe a duty of care to the charity which requires them to manage and preserve the charity's assets, and to take reasonable steps to insure that the charity is financially solvent and able to meet its financial obligations. The reasonable steps taken by the directors should include ensuring that pledged donations are collected. When a binding pledge is made, it immediately becomes an asset of the charity, and a legal obligation of the donor. Under this principle, if the donor is able to fulfill the pledge, the charity's board should assert its claim (in order to preserve it) and try to recover as much of the pledge as possible using litigation if necessary.

Second, IRS rules prohibit a charity from simply giving its assets away, except to other charities, or making decisions that enrich private parties at the expense of the charity. As noted above, once a binding pledge is made, it becomes an asset of the charity in the form of a legal debt obligation. Forgiving such a debt without a reasonable basis could be construed as a gift back to the donor, which would be improper. While no court has ever held directors liable for refusing to enforce a pledge, the IRS has recently issued new rules prohibiting charities from conferring non-incidental benefits on private parties, and this kind of scenario could potentially fall within these new rules.

Third, the parties must be alert to potential conflicts of interest. If a director or officer of the charity is the donor, for example, that director or officer should not be involved in the discussion about whether or not to commence legal action, and should not vote on the matter. Moreover, any directors who have an outstanding pledge to the charity at the time a dispute or issue arises regarding pledge enforcements should disclose that information to the board and recuse themselves from any discussion of policy regarding the enforcement of pledges. These rules extend to cover spouses, domestic partners and business partners (subject to certain technical conditions set forth in applicable Treasury Regulations.)

What Other Factors Should a Board Consider When Deciding Whether or Not to Enforce a Pledge?

Many organizations have adopted gift acceptance policies which cover the acceptance of pledges and their enforcement. In the absence of such a policy – or if the policy does not provide adequate guidance, the following factors can –and should – be discussed:

- Is the pledge in writing?
- Are the terms of the pledge clear and unambiguous?
- Does the donor have the ability to fulfill the pledge?
- Does the donor have legitimate counterclaims or defenses against claims to collect the pledge?
- Does the amount likely to be recovered justify the expense of collection?

- Would enforcement damage relations with other donors or outside parties to the extent that any recovery would be offset by lost funding opportunities?

Summary. The bottom line is this: with rare exceptions, charities have the right to enforce and collect pledges that they have accepted, especially if they have acted in reliance of the promise. With rare exceptions, charities are not required to sue donors, and indeed they should consider the long and short term effects of a lawsuit before doing so. The potential damage such a lawsuit might do to relationships with other donors and the expense of litigation relative to the amount that might be recovered are legitimate issues that can justify a board's decision not to seek enforcement of a pledge. A decision by the Board not to enforce a pledge should be carefully documented in the Board's minutes or in a resolution. If a charity does decide to enforce a pledge, the case will be treated more or less like an ordinary breach of contract action, with the caveat that courts tend to favor charities in these disputes.

For more information, contact the law firm of Perlman & Perlman, LLP, 41 Madison Avenue, New York, NY 10010 212-889-0575 and ask to speak to one of our exempt organization attorneys:

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