One Foundation's Legal Battle: A Cautionary Tale for All Nonprofits

As absorbing as a mystery story and full of lessons for every nonprofit, this saga includes heroes and villains, plot twists, and an ending in which justice prevails. Here's a birds-eye view from a lawyer involved in the case.

By Joseph Woodruff

Critics of what's called the "civil justice system" may have a point. Civil litigation is often hideously expensive and produces results that no ordinary observer would recognize as justice. The State of Tennessee's efforts to preserve the Maddox Foundation's assets prove, however, that it's a mistake to dismiss litigation out of hand and to complain that nothing good ever comes from a lawsuit.

Indeed, Tennessee's three-year legal battle to correct management abuses in the Maddox Foundation ended up providing a $55-million endowment that otherwise wouldn't have existed to support charities. And the battle ultimately reformed a decades-old trust agreement and put in its place a structure to achieve best practices for nonprofit board members.

The story of the Maddox Foundation litigation — lawsuits in three states; a Mississippi judge who was removed from the case by the Mississippi Supreme Court; attempts by Mississippi authorities to thwart decisions made by a Tennessee judge; multiple trips to state appellate courts and federal trial courts; and an examination of the proceedings by the tax-writing Finance Committee of the U.S. Senate — is too rich to be detailed in a single article. But the facts provide an object lesson for nonprofit organizations, the boards and executives who operate them, and the governmental authorities who regulate them.

> This unprecedented legal battle ended up providing a $55-million endowment that otherwise wouldn't have existed to support charities.

The Background in a Nutshell

The Maddox Foundation was established in Nashville, Tennessee, as a private foundation by Dan Maddox, a self-made millionaire who accumulated a substantial fortune through hard work and keen business judgment. Over 30 years, Mr. Maddox and his second wife, Margaret, used the Foundation to support a variety of philanthropic activities, especially Belmont University and the YMCA. The Foundation's board changed several times and, by 1997, it consisted of Mr. and Mrs. Maddox, their step-granddaughter, Tommye Maddox Working, and Mr. Maddox's executive assistant, Robin Costa.

The trust agreement establishing the Foundation required that the number of trustees never be less than three. It also contained an awkwardly worded provision that allowed the Foundation to be operated in the form of a nonprofit corporation. These two clauses and the requirement that the Foundation be operated for tax-exempt charitable purposes provided the Foundation's only governance structure — a feature that worked well enough so long as Mr. and Mrs. Maddox were alive. All of that tragically changed on January 14, 1998, in the pre-dawn fog on a Louisiana bayou when their boat was rammed by a barge.

The deaths of Mr. and Mrs. Maddox left Robin Costa and Tommye Working as the sole Foundation trustees and Robin as co-executor of the Maddoxes' estates. All of Dan Maddox's assets passed to his wife. Her will made some charitable bequests, and the remaining $114,000,000 passed to the Maddox Foundation.

Robin Costa soon emerged as the more influential of the two trustees. Tommye admired Robin for her education – Robin was a lawyer – and business acumen. Tommye deferred to Robin on a number of crucial decisions, including whether they were required by the trust agreement to elect a third trustee; whether to reorganize the trust into a not-for-profit corporation; and whether to relocate the Foundation to a jurisdiction whose laws would allow for less than three directors.

By the summer of 2000, documents had been signed to relocate the Foundation from Tennessee to Mississippi and to transfer the Foundation's assets to a newly created Mississippi nonprofit corporation, the sole controlling director of which was Robin Costa. Although Tommye Working resigned

continued on page 24

as a trustee and was appointed a corporate director, her term was time-limited, and the corporation's by-laws placed all meaningful power in Robin Costa's hands.

The Foundation's operation over the next four years would later be characterized by an expert witness as "turning philanthropy on its head." During this period, more than 65% of the Foundation's expenditures was spent on something other than grants to charities. Among those expenses were more than $300,000 for private airplane charters, over $3 million in professional fees, $1 million to purchase and renovate a Victorian mansion for the Foundation's headquarters, and most controversial of all, $9.5 million to purchase and operate two minor-league professional sports teams — the River Kings, a Central Hockey Association franchise, and the Explorers, an indoor football team. While the Foundation was, according to its critics, misusing money in a way that placed its tax-exempt status in jeopardy, its president, Robin Costa, paid herself over $3 million in multiple capacities — from the Foundation as its president and the Maddox Estates as co-executor.

Eventually, realizing that the Foundation wasn't being operated in accordance with her late-grandparents' wishes, Tommye Working decided to do something about it. Her efforts to engage the proper authorities in Mississippi proved fruitless so she met with Nashville's District Attorney General, Victor S. "Torry" Johnson III. He filed a civil suit under a little-used Tennessee statute that empowers district attorneys to sue to correct abuses in charitable trusts and corporations. Tommye engaged the law firm of Waller Lansden Dortch & Davis to represent the State of Tennessee on behalf of the charities that were to benefit from the Maddox Foundation.

The Lawyers Enter the Story

My colleagues and I found the case every bit as complex as Attorney General Johnson anticipated. Thousands of pages of documents had to be reviewed, digested, and indexed for future use. Complex issues of federal law dealing with tax-exempt organizations had to be analyzed. Witnesses in 12 states had to be interviewed and deposed. Expert testimony on fiduciary standards of care and program-related investments had to be obtained. And a vigorous defense had to be parried. Tennessee, however, made steady progress.

The first of many issues was that of jurisdiction. How could Tennessee officials hold accountable the executive officer of a Mississippi nonprofit? The answer was both complex and sublime: The Maddoxes' estates were probated in Nashville, Robin Costa was a co-executor, and she remained subject to the Tennessee Probate Court's supervision. Moreover, when Robin signed documents to move the Foundation to Mississippi, she failed to comply with requirements set out in a Tennessee statute.

Throughout the lawsuit, the Foundation's lawyers objected to the Probate Court's jurisdictional power. The probate judge, however, ruled that the case was properly before him, and the Tennessee Court of Appeals ultimately affirmed this conclusion.

Fortunately, two months before the State filed its lawsuit against the Foundation, Tennessee had adopted the Uniform Trust Code (UTC). Designed to protect trust assets, the UTC (www.utcproject.org) has been enacted in 21 states. Because Tennessee was one of those states, we were armed with a broader array of legal remedies than would otherwise have been available. Among those remedies was the Court's power to appoint special fiduciaries and a new trustee.

Calling on this power, we persuaded the judge to appoint accountants to examine the Foundation's books and a fiduciary to serve as trustee to the trust. The trust was still in existence because, as the Probate Court and Court of Appeals ruled, attempts to move it to Mississippi and have it dissolved were legally defective.

Unprecedented Rulings and Reforms

The case (*State of Tennessee, etc. v. Maddox Foundation, et al.*) was settled when Robin Costa agreed to return $55 million to the trust. The settlement was contingent on the IRS issuing a private letter ruling (PLR) that the settlement wasn't a "transfer" of assets between two private foundations. The IRS issued this unprecedented ruling, and $55 million that might have been squandered came back to the trust as an endowment to benefit charities.

Next, the Attorney General amended the trust's governing document. The new trust agreement was designed to avoid the problems that plagued the Foundation. Among these reforms:

• a prohibition against changing the trust's principal place of administration

• an expanded board of trustees grouped in classes that serve staggered terms

• a requirement for an annual audit

• a requirement for standing committees for (1) investments, (2) compensation, and (3) the annual audit

• a prohibition against trustees giving grants to recipients with whom the trustee is affiliated

• a requirement for competitive selection of service providers

• annual public reporting requirements

• a prohibition against fundraising activity by trustees. (As it was Mr. and Mrs. Maddox's intention that the foundation exist as a permanent endowment that made grants to charities, and since some of the excesses engaged in by foundation management involved excessive spending on lavish parties masquerading as "fundraising," the new trust agreement was drafted to prohibit trustees in Tennessee from engaging in activities to solicit contributions. The trust is authorized to accept unsolicited and unrestricted contributions and bequests but cannot spend trust funds to host a gala ball.)

Justice At Last

When putting the final touches on his estate plan, Dan Maddox told his lawyer that he and Margaret wanted their fortune to be applied after their deaths to "help in Nashville's problems." It took three years of hotly contested litigation to do it, but in the end the civil justice system achieved the Maddoxes' goal.

Nonprofit World • Volume 26, Number 5 September/October 2008
Published by the Society for Nonprofit Organizations
5820 Canton Center Road, Suite 165, Canton, Michigan 48187
734-451-3582 • www.snpo.org

> The Foundation's operation would be characterized by an expert witness as "turning philanthropy on its head."

Lessons for Your Organization

Nonprofit executives and board members can draw beneficial lessons from the example of the Maddox Foundation litigation. Among those lessons:

If a governing document provides for certain procedures, the board should follow those procedures faithfully.

If a governing document fails to provide a governance structure, then the board should adopt one and adhere to it.

There are no good substitutes for transparency of operations and accountability of officers and board members.

The reforms the Attorney General made to the trust's governing document clearly signal best practices every nonprofit organization should follow. Be sure your board adheres to these tenets of good governance:

Form an audit committee of several board members. This committee should hire an outside firm to audit the organization's finances every year.

Set up board standing committees – committees that stay in place, in contrast to short-term committees that accomplish a special task and then disband. Standing committees serve a vital role by bringing plans to the board for their decisions and action.

Create a conflict-of-interest policy, ethics statement, whistle-blower process (including a non-retaliation policy to assure that those who report problems won't face reprisal), document-retention policy, and other policies and procedures to assure good governance. Be certain the organization abides by all laws, regulations, and reporting requirements.

Review your organization's bylaws regularly, revise them if necessary, and have an attorney look them over to be sure they incorporate the latest legal prerequisites.

Conduct periodic self-assessments to be certain that all board members (and the board as a whole) are adhering to good practices. ■

Don't Let It Happen to You

Avoid lawsuits and intrusion by the IRS and other government officials by reading and taking to heart these *Nonprofit World* articles (available for download at www.snpo.org):

Can Standing Committees Contribute to High-Impact Governing? (Vol. 25, No. 6)

How to Assess & Improve Your Board's Performance (Vol. 24, No. 1)

Nonprofits without Audit Committees Risk Disaster (Vol. 22, No. 2)

Conflict of Interest in the Board Room (Vol. 17, No. 2)

10+ Self-Audit Tips for Nonprofit Accountability (Vol. 22, No. 4)

Got Bylaws? (Vol. 26, No. 4)

How to Find the Perfect Auditor (Vol. 22, No. 3)

33 Keys to a Trustworthy Organization (Vol. 26, No. 3)

The Ethics Audit: A Tool Whose Time Has Come (Vol. 13, No. 6)

Also see Learning Institute programs on-line: Board Governance (www.snpo.org/li).

Joseph Woodruff (joseph.woodruff@wallerlaw.com, 615-850-8485) is a partner at Waller Lansden. He has extensive trial and appellate experience as well as in mediation, arbitration, and other alternative forms of dispute resolution.