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ICCFA Magazine spotlight

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Federal and state laws can make it difficult to keep municipal, sectarian and other nonprofit cemeteries healthy over time. Operating agreements offer a way to address some of the problems unintentionally caused by these laws.

How an operating agreement can help ensure the future of a nonprofit cemetery

In order to succeed from generation to generation, cemeteries require capital and managerial resources. For nonprofit cemeteries, it can be particularly difficult to ensure that these resources remain available. Much of this can be attributed to the unintended consequences of federal and state laws that require the assets of a nonprofit to remain dedicated to a charitable purpose.

Under state law, the attorney general is charged with enforcing the nonprofit law and with ensuring that nonprofit corporations observe their charitable trust and do not engage in private inurement.

The doctrine of charitable trust requires that assets that have been dedicated for a charitable purpose must remain so dedicated, and private inurement prohibits a nonprofit from conferring a benefit upon a private person or individual.

Similar concepts apply to nonprofit, tax-exempt corporations at the federal level. The effect of these legal requirements upon nonprofit corporations can be multi-fold:

a. Difficulty of providing necessary board direction and oversight as a result of a volunteer board that may lack the continuity, commitment and expertise among its directors.

b. Restricting professional development and depriving the nonprofit of the talent and experience required to make a nonprofit grow as a result of the limited ability to incentivize senior management.

c. Difficulty accessing capital as a result of restrictions on borrowing funds and the legal impossibility of accessing equity.

d. Limited ability of nonprofits to pursue joint venture and acquisition strategies.

The unintended consequences of state and federal law, in turn, can have further ramifications. For example, the limitations of the nonprofit form can leave the nonprofit cemetery ill-prepared to meet current challenges or to formulate a plan of succession.

In addition, the weaknesses within the nonprofit form can leave it vulnerable to abuse and even fraud. This can take many forms but usually involves financial benefit improperly flowing from the nonprofit to a private person or individual.

Some nonprofit cemeteries have looked to management agreements as a way to overcome the limitations of the nonprofit form. Unfortunately, while a manager can bring current managerial expertise and even certain efficiencies and economies to the nonprofit cemetery, a management agreement does not address all of the shortcomings inherent in the nonprofit form discussed above.

As a result, the boards of nonprofit cemeteries and their advisors have looked for other arrangements to address these shortcomings. The operating agreement has emerged as one such arrangement.

In an operating agreement, a third party experienced in cemetery operations (the "operator") contracts to operate the cemetery for a term of years for which the operator receives the operating rights of the cemetery during the term. This entitles the operator to sell exclusively burial rights in the cemetery during the term of the operating agreement.

Further and depending on the extent of current operations in the cemetery and opportunity for future expansion, the operator may make payments to the nonprofit as further consideration for the grant of operating rights. Whether or not the operator makes these payments, as well as

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the appropriate amount of payments, will turn on the fair value of the operating rights determined as part of an outside, independent valuation. These monies become the exclusive property of the nonprofit to be used as it determines, consistent with the charitable purpose of the nonprofit.

For example, a nonprofit may use these payments and related income and appreciation realized during the term of the operating agreement to fund a perpetual care trust that will be used to maintain the cemetery after the agreement's expiration. Alternatively, a nonprofit may choose to undertake some historical preservation that is not considered part of the operator's obligation for maintenance and upkeep.

During the term of the operating agreement, the operator retains all revenue related to the sale of burial rights, including burial spaces and cemetery goods and services, and assumes complete financial responsibility for the operation of the cemetery. These financial responsibilities include operating expenses, performance of customer contracts as well as capital expenses related to maintenance and upkeep.

The operator also is responsible for contributions to the cemetery's perpetual care and merchandise trusts and is entitled to the distributions from the merchandise trust. For purposes of maintaining tax-exempt status under §501(c)(13) of the Internal Revenue Code, the nonprofit may choose to retain title to its perpetual care trust, though it may agree under the operating agreement that perpetual care income may be applied toward maintenance and upkeep expenses of the cemetery incurred during the term of the operating agreement.

The effect of the foregoing is twofold. First, it shifts the financial responsibility of the cemetery to the operator. Second, it allows the nonprofit to redirect assets away from operations, maintenance and upkeep that the operator will now perform and toward some other aspect of the nonprofit's charitable mission.

During the term of the operating arrangement, the board of the nonprofit continues to exercise responsibility for the property and affairs of the nonprofit, and in so doing, oversees the performance of the operator.

In the discharge of its fiduciary duties to the nonprofit, the board may review budgets, financial statements, trust statements and performance reports, all prepared by the operator as required under the operating agreement. The board may change the manner in which the operator accounts to the board, notify the operator of nonperformance, require certain remedial steps or even replace the operator.

Upon expiration of the term of the operating agreement, all improvements, equipment, executory customer contracts, merchandise trust funds and customer accounts receivable relating to cemetery operations pass back to the nonprofit.

In exchange for the relinquishment of rights in these assets, the operating agreement provides for payment of termination costs to the operator. These may include increases in receivables from customer contracts, increases in the net profit of pre-need contracts held in trust and to be performed in the future (amounts in trust less merchandise liabilities), certain unamortized costs of capital improvements and certain unamortized costs of equipment.

The advantages of operating agreements

Cemetery management agreements grew out of the limitations that the nonprofit form presents. The operating agreement has developed as a result of the failure of some cemetery managers to address fully the limitations of the nonprofit form.

The primary way in which the operating agreement accomplishes this is to shift the financial risk of operation of the cemetery from the nonprofit to the operator. In so doing, the operating agreement allows the nonprofit to more favorably address areas of concern than it can do acting alone or as part of a management agreement.

The following items illustrate the advantages of an operating agreement over a management arrangement or a nonprofit that chooses to operate its cemetery directly:

1. Term of agreement and control. Ideally, the managed nonprofit cemetery wishes for a long-term relationship with a board independent of the manager overseeing its stewardship. Unfortunately, nonprofit, tax-exempt status requires an agreement with a limited term of one to five years.

In turn, the requirement of a shorter term creates a tension that encourages the manager to seek representation on the nonprofit board, which may be inconsistent with good governance and, if it rises to the level of control, may constitute impermissible private benefit.

These concerns do not exist under the operating agreement. The tax-exempt status of the cemetery is not dependent on the term of the operating agreement, which, therefore, may provide for a term of many more years.

As a result, the reasons that a manager may push for a voice in governance or even control of the nonprofit board are not present or are addressed in more acceptable ways under the operating agreement.

2. Private inurement/private benefit. As noted in item 1, the operating agreement, compared with a management agreement, can reduce the risk of private inurement or private benefit.

In addition, simple steps such as a fair value assessment of the operating arrangement by an outside consultant, separate legal representation of the nonprofit and the operator and full disclosure of the operating arrangement to the state regulatory authority can further mitigate the risk of private inurement.

3. Aligning risk. In a managed arrangement, the manager manages the cemetery for the benefit of its principal, the nonprofit cemetery. As a result, costs associated with the compensation and benefits of employees, day-to-day operating expenses, performance of customer contracts, maintenance and capital improvements all fall to the nonprofit.

With the operator fully responsible for maintenance and upkeep of the cemetery, the assets of the nonprofit are available for special projects as its board determines at its discretion, with the opportunity to grow these funds through fundraising and grants.

Typically, the manager participates in none of these expenses, even though the management agreement vests day-to-day responsibility for operation of the cemetery in the manager.

An operating arrangement is structured in a very different way. An operator is financially responsible for the cemetery and each of the above items. The fortunes of the operator, therefore, rise and fall on its ability to operate the cemetery profitably over the short and long term.

Further, because the operating agreement is for an agreed term of years, all improvements, equipment, executory customer contracts, merchandise trust funds and customer accounts receivable pass back to the nonprofit upon termination of the operating agreement.

4. Management fee, compensation of senior staff and revenue in excess of expenses. Typically, the management fee in a management arrangement is based on some percentage of revenue. In addition, some management agreements provide for the cost of senior staff to be paid by the nonprofit. These arrangements create several challenges.

First, they do not reflect performance and, therefore, are not designed to reward effective management or penalize ineffective management.

Second, they have a potential for abuse. A management fee that is set too high unfairly passes the benefits of nonprofit, tax-exempt status to a private person and, in so doing, provides an impermissible private benefit.

Third, in the absence of appropriate board oversight, the potential for abuse can expand to manager schemes designed to pass any revenues in excess of expenses generated within the nonprofit to the manager as additional fees.

The operating agreement avoids all of this. The operator has contracted to operate the nonprofit cemetery for a term of years for an agreed payment, with such payment becoming the property of the nonprofit, along with its other assets, including any consideration paid by the operator to the nonprofit under the terms of the operating agreement.

During the term of the operating agreement, the operator keeps all revenue and pays all expenses. Any return that the operator enjoys derives from its ability to properly and efficiently operate the cemetery for which it is accountable to the nonprofit board. A failure on the part of the operator to do so can lead to a claim for damages as a result of breach, termination or a "forced" sale of the operator agreement to another operator.

5. Access to capital and creditworthiness. Nonprofit cemeteries are limited in their ability to access capital. The nonprofit form does not permit equity investments, and lenders can be reluctant to extend credit given the limitations of the nonprofit form discussed above.

The management arrangement does not improve upon this. Even if the manager can provide capital, charitable trust and private inurement considerations limit the ability of the nonprofit to join the credit of its manager. Similarly, charitable trust and private inurement restricts equity investments in the nonprofit by outside investors.

An operating agreement can overcome these limitations. To the extent the operator is part of a diversified death care company, the operator often can access credit as part of a borrowing group.

Further, the operating agreement is more likely to afford greater creditworthiness as a result of a structure more familiar to lenders, the availability of other resources through entities related to the operator and the ability to consider the strength of the operator.

Factors contributing to this last item include the longer term of the operating agreement and the predictability of the revenue stream reflected in the financial statements of the operator.

6. Financial strength and ability to address current and future challenges. In a management agreement, the assets of the manager are not available to support the cemetery. Financial strength is limited to the assets of the nonprofit cemetery. The limitations of the management arrangement discussed above also restrict its ability to accommodate current and future challenges, including transformational change such as the shift from traditional burial to cremation.

Contrast this to the operating agreement where the assets of the nonprofit are not directly exposed and those of the operator are fully at risk, which through guarantees of related entities may extend across a diversified death care system.

In addition, and unlike in the management arrangement, the indirect risk to the assets of the nonprofit cemetery may be limited and further minimized by a fair-value opinion of the operating arrangement, independent legal representation of the nonprofit and an independent nonprofit board.

Finally, with the operator fully responsible for maintenance and upkeep of the cemetery, the assets of the nonprofit are available for special projects as its board determines at its discretion, with the opportunity to grow these funds through fundraising and grants.

The effect of all of the foregoing is to provide greater opportunity for flexibility and innovation in the responses of the operator and the nonprofit to change in any form.

Succession and acquisition strategies are a form of transformational change, which the operating agreement better accommodates than the management agreement. For the reasons discussed above, the operating agreement is better suited to developing managerial talent and to grooming an effective, independent nonprofit board.

Because the results of the operator are reflected in its financial statements and not those of the nonprofit, the operating agreement better accommodates its sale and, unlike the management agreement, does so without running afoul of charitable trust and private inurement concerns.

7. Bankruptcy. An operating agreement also may afford advantages in the event of the bankruptcy of the nonprofit. Unlike a management agreement, which a trustee or a debtor in a bankruptcy case may reject, an operating agreement may be characterized as a lease of non-residential real property which, if rejected, entitles the operator to retain certain rights under the operating agreement.

This retention of rights, which is not available under a management agreement, can afford advantages to the operator. Primary among them is protecting the operator's ongoing interest in the operating arrangement. In certain circumstances, there also may be advantages to the nonprofit, such as maintaining its charitable or religious mission.

8. Downside to the operating agreement

While the operating agreement affords numerous advantages over the management agreement, an operating arrangement may prove more difficult to implement than an amended management arrangement.

Management arrangements with nonprofit cemeteries have a long history, with familiarity and comfort developing during this history among nonprofits, managers and regulators. Not so with the operating agreement, which lacks this history and certainty rooted in experience of moving to an operating arrangement.

Further, moving to an operating agreement can entail considerably more time and expense compared to implementing a new management arrangement or amending an existing management agreement. Finally, certain states, such as New York and New Jersey, narrowly proscribe the oversight of cemetery operations by outside third parties. Obtaining regulatory approval of an operating agreement in these states may prove more difficult.

For the foregoing reasons, a management agreement may prove easier to implement than an operating agreement, notwithstanding the advantages of the latter. In these instances, the more practical choice may be to pursue implementation of an operating agreement over time, which begins with negotiation of certain changes to the management agreement.

Some might also object that an operating agreement is a de facto sale of a cemetery, triggering additional review of charitable trust and private inurement issues by state authorities.

In fact, the term of the operating agreement, the retained authority of the nonprofit board and the relinquishment of certain rights in cemetery assets explain why the operating agreement is not a de facto sale.

An operator might choose to voluntarily submit an operating agreement for review by the relevant state regulatory authority as part of licensure. Such action would extend the regulator's authority to the operator, including sales activities related to burial spaces and cemetery goods and services, and would provide openness and transparency that could alleviate concerns that the agreement sacrifices public good for private benefit.

This contrasts with cemetery management companies that tend to view themselves as not subject to state regulatory authority and choose not to voluntarily disclose the terms of their management arrangements.

Finally, the financial arrangement between operator and cemetery ensures that the cemetery has adequate cash flow, and the review of the operating agreement for fair value supports the conclusion that there is no violation of charitable trust or private inurement.

Operating agreements have been found to address concerns relating to charitable trust and private inurement under state law. The Offices of the Attorney General for the State of Ohio and the Commonwealth of Pennsylvania have found operating agreements negotiated between a nonprofit corporation and an operator to be consistent with the requirements of charitable trust and private inurement as interpreted in those jurisdictions.

In Pennsylvania, the Orphans' Court for Philadelphia County has agreed with the decision of the Office of Attorney General.

While the Internal Revenue Service has not yet commented upon an operating agreement, the favorable determinations at the state level suggest that the IRS would reach a similar conclusion with regard to charitable trust or private inurement as a matter of U.S. tax law.

Conclusion

This article has discussed the difficulty of operating a cemetery through the nonprofit form. Under an operating agreement, an operator agrees to be fully at risk for the operations of a cemetery over an agreed term of years.

An operating agreement overcomes many of the limitations of the nonprofit form, as well as those of the management arrangement, and thereby better secures the future of the nonprofit cemetery.

It is suggested that the boards of nonprofit cemeteries, whether nonsectarian, religious, historical or municipal, consider the operating agreement as a means to secure the future of a nonprofit cemetery.

Likewise, state regulatory bodies might look to the operating arrangement as a way to secure the future of nonprofit cemeteries and avoid the prospect of a distressed or abandoned cemetery that will create burdens for families, communities and local and state governments.

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