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Not-for-Profit Alert

New Governance Rules for New York Not-for-Profit Corporations – It's Time to Prepare

By Gabriel Gershowitz

Not-for-profit corporations incorporated under New York law will soon be subject to new governance and oversight rules, the highlights of which are summarized in this alert.[1] Subject to certain exceptions, most of the provisions will become effective on July 1, 2014. As discussed in more detail below, New York not-for-profit corporations should review and prepare to modify, if necessary, their governance structure, oversight functions, policies, and day-to-day operations to ensure compliance with the upcoming changes to New York law. Most of the provisions of the new law summarized below apply to not-for-profit corporations incorporated under New York law (regardless of whether they are tax-exempt under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the Code)); however, provisions described in the "Independent Audit Oversight" paragraph below relating to financial audits and reporting also apply to not-for-profit organizations incorporated elsewhere but registered in New York for charitable solicitation purposes. Certain provisions of the new law also apply to charitable trusts that are subject to the New York Estates, Powers and Trusts Law.

The Non-Profit Revitalization Act (the Act), which was passed by the New York State legislature this past summer and signed into law by the Governor in December 2013,[2] effects material changes to various laws in New York applicable to not-for-profit corporations. It represents the first major overhaul of the state's Not-for-Profit Corporation Law (the N-PCL) in over 40 years. The Act focuses primarily on: (i) internal governance and oversight reforms; (ii) processes and procedures relating to specified corporate transactions, such as a merger, consolidation, or transfer or sale of all or substantially all of a not-for-profit organization's assets; and (iii) elimination of certain statutory and administrative requirements considered to be outdated and/or unnecessarily burdensome and confusing. Set forth below is a chart summarizing the applicability of the Act, followed by summaries of its key provisions. At the end of this alert, we include recommendations on "what to do now."

Not-for-Profit Corporations to Which the Act Applies[3]

Type of Entity	Scope of Applicability
New York not-for-profits:	
■ Not-for-profit corporations incorporated in the State of New York (referred to in this chart as "NY NFPs")	Entire Act except where noted below
■ NY NFPs that are not registered in NY for charitable solicitation purposes	Not required to comply with any provisions discussed under "Independent Audit Oversight" below
■ NY NFPs that have $500,000 or less annual gross revenue	Not required to comply with any provisions discussed under "Independent Audit Oversight" below
■ NY NFPs that have annual revenue of $1 million or less	Not required to comply with certain provisions discussed under "Independent Audit Oversight" below
■ NY NFPs that have fewer than 20 employees and annual revenue of $1 million or less	Not required to comply with any provisions discussed under "Whistleblower Policy" below
Not-for-profits incorporated outside of New York:	
■ Registered in NY for charitable solicitation purposes and with gross revenues in excess of the thresholds described in "Raising Thresholds Requiring an Independent Audit or Accountant Review"	Required to comply with provisions discussed under "Independent Audit Oversight" below
■ Authorized to conduct or conducts activities in NY	Generally not required to comply; however, Act provisions related to mergers are applicable

Requirement	Gross Revenue & Support Threshold Applicability			
	Until June 30, 2014	**July 1, 2014 until June 30, 2017**	**July 1, 2017 until June 30, 2021**	**Beginning July 1, 2021**
Audit report	In excess of $250,000	In excess of $500,000	In excess of $750,000	In excess of $1 million
Review report	$100,000 to $250,000	$250,000 to $500,000	$250,000 to $750,000	$250,000 to $1 million

Internal Governance and Oversight Reforms

The Act amends corporate governance requirements applicable to New York not-for-profit corporations in the following notable ways:

- **Non-Employee Chair.** No employee of the not-for-profit may serve as chair of the board or hold any other title with similar responsibilities. This requirement becomes effective January 1, 2015. The Act provides no "grandfather" rule.
- **Raising Thresholds Requiring an Independent Audit or Accountant Review.** The Act amends the New York Executive Law to raise the gross revenue and support thresholds that trigger the requirements that not-for-profits that are registered in New York for charitable solicitation purposes obtain and file with the New York Attorney General an independent certified public accountant audit report or review report, as set forth above. In addition, charitable organizations which use paid fund-raisers will no longer be required to obtain an audit report unless they meet the gross revenue and support thresholds.
- **Independent Audit Oversight.** The Act requires that, in the case of any not-for-profits required to file an independent certified public accountant's audit report with the Attorney General (as discussed above), either the full board or an audit committee comprised entirely of independent directors (with only independent directors participating in deliberations and voting) is required to:
  - oversee the accounting and financial reporting of the organization and the audit of the organization's financial statements;
  - annually retain the independent auditor;
  - review the results of the audit and any related management letter with the independent auditor; and
  - in the case of a New York not-for-profit expected to have annual revenues in excess of $1 million:
    - review with the independent auditor the scope and planning of the audit prior to its commencement;
    - upon completion of the audit, discuss with the independent auditor material risks and weaknesses in internal controls identified by the auditor, any restrictions on the scope of the auditor's activities or access to requested information, any significant disagreements between the auditor and management, and the adequacy of the corporation's accounting and financial reporting processes; and
    - annually consider the performance and independence of the independent auditor.
- **Independent Directors.** Unless the board already performs such governance activities, New York not-for-profits will need to form an audit committee composed of "independent" directors or identify "independent directors" to oversee the audit (if any), approve certain transactions, and oversee the conflict of interest policy and the whistleblower policy (if any). Note that only independent directors may participate in any board or committee deliberations or voting relating to such matters. The Act does not prescribe a minimum number of audit committee members although the N-PCL generally requires that committees of the board have at least three members. The Act defines "independent director" as a director who meets the following "bright-line" tests:
  - is not, and has not been within the last three years, an employee of the corporation or an affiliate of the corporation, and does not have a "relative" who is, or has been within the last three years, a "key employee" of the corporation or an affiliate of the corporation;
  - has not received, and does not have a relative who has received, in any of the last three fiscal years, more than $10,000 in direct compensation from the corporation or an affiliate of the corporation, other than reasonable compensation for service as a director; and
  - is not an employee of or does not have a substantial financial interest in, and does not

have a relative who is an officer of or has a substantial financial interest in, any entity that has made payments to, or received payments (not including charitable contributions) from, the corporation or an affiliate thereof for property or services in an amount that, in any of the last three fiscal years, exceeds the lesser of $25,000 or two percent of such other entity's consolidated gross revenues.[4]

- **Mandatory Related Party Transaction Procedures and Ability of Attorney General to Unwind.** Prior to undertaking a transaction with a "related party,"[5] the board of a New York not-for-profit must first determine if the proposed transaction is fair, reasonable, and in the corporation's best interest. This requirement applies to *all* related party transactions – there is no *de minimis* threshold. In addition, for "charitable organizations" (described below under "Eliminating Organization Types"), where a related party has a "substantial financial interest" in a proposed transaction, the board (or authorized committee) must follow certain procedural requirements, including the consideration of alternative transactions to the extent available, majority board or committee approval, and contemporaneous documentation of the board's considerations and decision.[6] Notably, the Act enhances the power of the Attorney General to bring an action to enjoin, void, or rescind related party transactions that have been entered into without complying with applicable procedural requirements, as well as to remove directors or officers, order payment of double the amount of certain improperly obtained benefits, or seek restitution.
- **Conflict of Interest Policy.** All New York not-for-profit corporations – regardless of size – will be required to adopt a conflict of interest policy applicable to directors, officers, and key employees. While some not-for-profits have previously adopted a conflict of interest policy, disclosure of which is required by IRS Form 990, the Act expressly mandates the adoption of such policy.[7] The Act requires that such policy, among other things: (i) define the circumstances that constitute a conflict; (ii) include procedures for disclosing, addressing, and documenting related party transactions (discussed above); (iii) prohibit a conflicted person from participating in deliberations or voting or influencing the vote; and (iv) require directors to disclose to the corporation (upon joining the board and annually thereafter) any entities with which they are affiliated and with which the corporation has a relationship, and any corporate transactions possibly giving rise to a conflict for the director. The board or audit committee (or other independent board committee) must oversee the adoption and implementation of and compliance with the policy, and only independent directors may participate in any board or committee deliberations or vote on matters relating to the policy.
- **Whistleblower Policy.** New York not-for-profits that have 20 or more employees and annual revenue above $1 million must adopt a whistleblower policy that includes procedures for reporting and investigating violations or suspected violations of law or corporate policies, and anti-retaliation provisions. In addition, the policy must designate a specific employee, officer, or director to administer the policy and report to the audit committee or the full board. The board or audit committee (or other independent board committee) must oversee the adoption and implementation of and compliance with the policy, and only independent directors may participate in any board or committee deliberations or vote on matters relating to the policy. Some not-for-profits have previously adopted whistleblower policies in response to applicable provisions of the Sarbanes-Oxley Act prohibiting retaliation against whistleblowers. IRS Form 990 also requires disclosure of any whistleblower policy.

Streamlined Corporate Transactions

The Act streamlines the state law hurdles associated with certain corporate transactions, including:

- **Eliminating Two-Step Approval for Certain Transactions.** Under existing law, a merger, dissolution, and certain other transactions (including, in the case of certain not-for-profits,

amending the charter by changing, eliminating, or adding a purpose or power) require both Attorney General and Supreme Court approval. Pursuant to the Act, certain transactions will no longer require both types of approvals – rather, they will only require Attorney General approval. However, court approval (i) will still be required if the corporation is insolvent or would become insolvent as a result of the transaction or if the Attorney General concludes that court approval is appropriate and (ii) will still be available to the organization if the Attorney General does not approve the transaction.

- **Majority Vote for Routine Real Estate Transactions.** The Act requires only a majority of the board or authorized committee to approve routine real estate transactions (such as the purchase, sale, mortgage, or lease of real property that does not constitute, after giving effect to the transaction, all or substantially all of the assets of the not-for-profit). However, a real estate transaction that constitutes an acquisition (after giving effect to the transaction) or disposition of all or substantially all of the assets of the not-for-profit still requires the approval of two-thirds of the entire board (or a majority of the entire board if there are 21 or more directors).

Simplified Formation and Day-to Day Operations

The Act includes features designed to simplify and reduce statutory and administrative requirements considered to be burdensome, including:

- **Permitting Electronic Meetings, Consent, and Communications.** The Act expressly permits electronic technology for certain meetings, notices, waivers, proxies, and other communications, and allows boards or committees to take action by written consent in electronic form. In certain cases, the Act permits website posting in lieu of newspaper publications.
- **Eliminating Organization "Types."** Ending a statutory construct that has caused decades of confusion and undue burden for the not-for-profit community, the Act replaces the "letter types" of not-for-profits ("A" through "D") with two basic categories: charitable and non-charitable. A "charitable corporation" means any corporation formed or deemed to be formed for charitable purposes. "Charitable purposes" are defined to mean purposes contained in the certificate of incorporation that are charitable, educational, religious, scientific, literary, cultural, or for the prevention of cruelty to children or animals. A "non-charitable corporation" means any not-for-profit corporation other than a charitable corporation, including but not limited to one formed for any one or more of the following non-pecuniary purposes: civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, or related to animal husbandry or for the purpose of operating a professional, commercial, industrial, trade, or service association. Type A not-for-profits incorporated before July 1, 2014, will be deemed "non-charitable," Type B and C not-for-profits incorporated before July 1, 2014, will be deemed "charitable," and Type D corporations formed before July 1, 2014, will be deemed "charitable" or "non-charitable," depending on the purposes as reflected in their existing charters.
- **Eliminating State Education Department Consent for Certain Entities.** The Act eliminates the requirement that certain not-for-profits obtain advance approval of the New York State Education Department for formation. Currently, not-for-profits involved in any type of education – such as "educating the public at large regarding social issues" – are required to obtain pre-approval from the State Education Department or the regents of the state university system. Under the Act, State Department approval will only be required for a school, library, museum, or historical society; note that the approval of the regents of the state university system is required for a college or university. Other not-for-profits whose charters include a purpose for which a corporation might be chartered by the regents of the state university system will be required only to provide the Commissioner of Education with a certified copy of the certificate of incorporation within 30 business days after formation.

- **Permitting Correction of Typographical or Similar Non-Material Errors in Certificates or Instruments.** The Act allows certificates and other instruments relating to not-for-profits that contain typographical or non-material errors to be corrected by e-mailing the New York Department of State.

What To Do Now?

- Review the organization's board leadership structure and succession plan to ensure that, by January 1, 2015, at the latest, the chair will not be an employee of the organization
- Determine which directors will qualify as "independent" in accordance with the Act's independence standards and, if necessary, plan to elect or appoint independent directors who will be responsible for providing oversight of the organization's conflict of interest policy, whistleblower policy (if any), audit oversight (where applicable), and other matters as prescribed by the Act
- Confirm whether it is anticipated that the organization's gross revenues and support are such that the organization's financial statements will be required to be audited or reviewed by an independent certified public accountant in light of the revised thresholds
- Review the organization's governing documents, policies, and procedures, including:
  - By-laws
    - Consider specifying that the chair of the board and/or any other individual holding a title with similar responsibilities must not be an employee and that the organization is required to adopt and comply with a conflict of interest policy and whistleblower policy (if applicable)
  - Audit committee charter (if any)
    - For organizations that are required to or otherwise file audited financial statements, determine whether the board or independent audit committee will be responsible for oversight of the organization's accounting and financial reporting processes and the audit of its financial statements
  - Conflict of interest policy and whistleblower policy
    - Any amendments to either of these policies should be approved by the board or independent audit committee
    - Consider incorporating into the conflict of interest policy the Act's disclosure and approval requirements with respect to related party transactions
  - Board guidelines and code of conduct
    - Make any conforming changes as needed

1. Groups intending to engage in activity for not-for-profit purposes tend to do so through the structure of a not-for-profit corporation or an unincorporated association. Other types of entities such as trusts or LLCs may also be used, although they are much less common (and note that New York does not have an LLC statute expressly permitting the formation of a not-for-profit LLC). This alert focuses primarily on not-for-profit corporations, but readers should be aware that there are alternative structures that may be utilized.
2. The Governor's Approval Memorandum filed on December 19, 2013, states that the bill as passed by the state legislature contains certain technical defects and barriers to implementation that the legislature has agreed to remedy via additional legislation. The Governor's signing of the bill is on the basis of such additional legislation. On January 8, 2014, New York State Senator Ranzenhofer introduced Bill S6249, which, according to the state legislature's website, represents discussions between the Governor, the Attorney General, the Senate, and the Assembly intended to implement the necessary "minor technical changes" to the Act noted in the Governor's Approval Memorandum. As of this writing, Bill S6249 was referred to and has been approved by the Senate Rules Committee and is expected to be voted on by the full Senate in the near future, although no companion legislation has yet been introduced in the Assembly. Please click on the following link to access the full text of the Act, Bill A8072-2013: http://assembly.state.ny.us/leg/?default_fld&bn=A08072&term=2013&Summary=Y&Text=Y.
3. Certain provisions of the Act also apply to certain wholly charitable trusts.

4. While, the terms "related party" and "independent director" are also relevant for the purposes of compliance with the tax laws, it should be noted that tax laws and the Act differ in their definitions of these terms.
5. A "related party" is defined by the Act as: (i) any director, officer, or key employee of the corporation or any of its affiliates; (ii) any relative of any director, officer, or key employee of the corporation or its affiliates; or (iii) any entity in which an individual described in clause (i) or (ii) has a 35 percent or greater ownership or beneficial interest or, in the case of a partnership or professional corporation, a direct or indirect ownership interest in excess of five percent. The Act defines a "related party transaction" as any transaction, agreement, or other arrangement in which a "related party" has a financial interest and in which the corporation or any of its affiliates is a participant. An "affiliate" of a corporation is defined as any entity controlled by, in control of, or under common control with such corporation. A "key employee" is defined as any person who is in a position to exercise substantial influence over the affairs of the corporation.
6. For a number of years, the Code has imposed analogous rules setting parameters around "related party" transactions. The so-called "intermediate sanctions" provisions of Code Section 4958 establish specific guidelines, similar (but not identical) to the procedures required under the Act, that serve to protect the not-for-profit organization from violating the prohibition against private inurement and thereby incurring penalties. Notably, the Code's guidelines in this area are not mandatory, but merely establish a "safe harbor," whereas the Act requires that a not-for-profit take specific steps prior to participating in a related party transaction.
7. IRS Form 990 (the annual tax return filed by most not-for-profit organizations) requires disclosure of whether the organization has a conflict of interest policy. The tax law (and IRS Form 990) does not require that an organization have a conflicts policy; however, the IRS believes that the absence of a conflicts policy is a factor suggesting substandard corporate governance, which (the IRS maintains) may lead to violation of tax law principles applicable to exempt organizations, and therefore warrants heightened scrutiny.

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