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nonprofit alert

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New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant Changes to New York Nonprofit Corporation Law on Horizon

The Nonprofit Revitalization Act, NY A8072 (the "Act"), a bill that makes comprehensive updates to the New York Not-for-Profit Corporation Law, as well as several other statutes related to nonprofits, recently passed both houses of New York's legislature unanimously. The Act is awaiting delivery to the Governor's office, at which time the Governor would have 10 days to take action or the bill would automatically become law, provided it is delivered before the end of the legislative session on December 31, 2013. The Act would be the first major revision to New York's nonprofit laws in over 40 years. Its provisions apply to nonprofits that are incorporated in New York, but one significant section – related to financial audits and financial reporting to the state – applies to all nonprofits that are registered in New York for charitable solicitation purposes.

If signed into law, most provisions of the new Act would be effective on July 1, 2014 (a couple of the provisions noted below would take effect in 2015, 2017, and 2021). The Act modernizes aspects of the current laws, including the incorporation of new technology options for holding meetings and taking action. The law also imposes standards for enhanced governance processes such as mandating that nonprofits of a certain size adopt conflict of interest and whistleblower policies, and it contains a new definition and approval process for related-party transactions. In addition, the law imposes new limitations and prohibitions on certain governance structures and practices, which may create significant challenges for particular organizations. Many nonprofits will find that they need to amend their governance documents, policies, and procedures – and, in some cases, significantly overhaul their governance structure – to comply with some of the detailed requirements of the Act.

The Act is based on recommendations from the Nonprofit Revitalization Group, convened by New York Attorney General Schneiderman, which recommended changes to cut red tape and eliminate outdated procedures to make it easier and more efficient for nonprofits incorporated in New York to operate. Some heralded these changes as welcome updates to create greater transparency in response to growing public mistrust of nonprofit governance. However, some of these changes may create practical challenges for many nonprofits that must now significantly revise their governance and oversight procedures in response.

Applicability

Generally, the Act only applies to nonprofits incorporated in New York. One section of the Act, however – relating to audit committees, related governance procedures, and financial reporting to the Attorney General – also applies to nonprofits which must register to conduct charitable solicitations in New York, regardless of where they are incorporated.

The major provisions of the Act are summarized below.

Elimination of Letter Types

One of the most substantial changes in the Act is the elimination of classification as Type A, Type B, Type C, and Type D. Nonprofits will instead now be classified as either "charitable" or "non-charitable." Existing organizations do not have to amend their governing documents to clarify whether the organization is "charitable" or "non-charitable." The Act provides that Type B and C entities, as well as Type D entities formed for a charitable purpose, will be deemed to be "charitable." Type A and all other Type D entities will be regarded as non-charitable.

Modernization and Streamlining of Nonprofit Governance Actions and Communication

Electronic Mail for Meeting Notice / Waiver of Notice / Unanimous Consent

The Act makes changes to reflect use of modern technology in governance. Prior to the Act, nonprofits were required to provide notice of member and director meetings by mail or in person. The Act now provides that notice, or waiver of notice, can be given by electronic communication such as e-mail. The Act also provides that electronic communication can be used by members to designate a proxy, and by directors and members to give unanimous written consent in lieu of an in-person meeting.

Video Conferencing for Board Meetings

Unless restricted by the corporation's certificate of incorporation or bylaws, the Act also allows members of the board to participate in a meeting of the board or any committee thereof through electronic video screen communication such as Skype, so long as all board members can hear each other at the same time and each director can participate in all matters before the board.

Enhanced Governance Procedures, Policies, and Prohibitions

Limitation on Employee Serving as Chair

In an effort to preserve the balance between the board and the executive staff of nonprofits, the Act contains an express prohibition on an employee serving as chair of the board or in an officer position with similar responsibilities. However, it should be noted that this prohibition would not extend to bona fide independent contractors. The Act provides that the board may appoint among its officers a chair or a president, or both. The prohibition on an employee serving as chair would presumably not apply to the president in an organization in which different individuals serve as chair and president.

The provision prohibiting employees serving as a chair has an effective date of January 1, 2015, one year later than the other provisions of the Act.

Compensation Approval

The Act provides that no person who may benefit from a compensation decision may be present at or otherwise participate in any board or committee deliberation or vote concerning that person's compensation, except that the board or committee may request that the person present information as background or answer questions at a board or committee meeting prior to the commencement of deliberations or voting thereon.

New Definition of "Independent Director"

The Act defines an "independent director" as an individual who meets all of the following criteria:

(1) has not been an employee of, or does not have a relative that was a key employee of, the corporation or an affiliate of the corporation in past three years;

(2) has not received, or does not have a relative that has received, $10,000 or more in direct compensation from the corporation or an affiliate in the last three years (other than expense reimbursement or reasonable compensation as a director);

(3) is not a current employee of or does not have substantial financial interest in an entity that made or received payments from the corporation or an affiliate of more than $25,000 or 2% of the corporation's gross revenue for property or services (whichever is less) in the last three years; and

(4) does not have a relative who is a current officer of or has a substantial interest in an entity making or receiving payments of a similar amount to the organization in the past three years.

The Act exempts payments of charitable contributions from the definition of payments, but does not contain an exemption for membership dues, which could trigger the "$25,000 or 2%" definition of independence and should be noted by an organization whose board consists of employees of member entities (which is common in trade associations as well as in other types of nonprofits).

This definition of independence particularly impacts audit oversight and administration of the organization's whistleblower and conflict of interest policies, as discussed below.

Mandatory Conflict of Interest Policy

The Act requires all nonprofits to adopt a conflict of interest policy covering directors, officers, and key employees. Some nonprofits may need to adopt a new conflict of interest policy, or update their current policy, to meet the new requirements. At a minimum, this policy must include (1) a definition of circumstances that constitute a conflict of interest, (2) procedures for disclosing a conflict to the audit committee or the board, (3) a requirement that the person with a conflict of interest not be present at or participate in board or committee deliberations or voting on the matter giving rise to such conflict, (4) a prohibition on any attempt by a conflicted person to influence board deliberations, (5) documentation procedures for detailing the existence and resolution of the conflict, and (6) procedures for disclosing and addressing related-party transactions. The Act provides that, prior to the initial election of any director, and annually thereafter, directors must complete, sign, and submit a written statement identifying any potential conflict, as defined in the Act. The board or designated audit committee of the board must oversee the adoption, implementation of, and compliance with any conflict of interest policy if this function is not otherwise performed by another committee of the board consisting solely of independent directors.

Related-Party Transaction Approval Process

In conjunction with the new conflict of interest policy requirement, the Act updates the definition of what constitutes a "related party," defined as (1) any director, officer, or key employee of the corporation or any affiliate of the corporation; (2) any relative of any director, officer, or key employee of the corporation or any affiliate of the corporation; or (3) any entity in which any individual described in (1) or (2) 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. A "related-party transaction" is defined as any transaction, agreement, or other arrangement in which a related party has a financial interest and in which the corporation or any affiliate of the corporation is a participant.

The Act prohibits all corporations from entering into any related-party transaction unless the transaction is fair, reasonable, and in the corporation's best interests. The Act contains additional requirements for charitable organizations (as opposed to non-charitable organizations, as defined by the Act) considering such transactions, including a requirement that the board consider alternative transactions to the extent available and approve the transaction by not less than a majority vote of the directors or committee members present at the meeting.

With regard to enforcement, the Act adds a provision allowing the New York Attorney General to bring an action to enjoin, void, or rescind any related-party transaction that is not reasonable and in the best interests of the corporation at the time such transaction was approved.

Mandatory Whistleblower Protection Policy

The Act also mandates that nonprofits with 20 or more employees and annual revenue in the prior fiscal year in excess of $1,000,000 institute a whistleblower protection policy. The whistleblower policy must protect from retaliation any director, officer, employee, or volunteer who in good faith reports an action or suspected action that is potentially illegal, fraudulent, or in violation of any adopted policy of the corporation. The policy must include procedures for reporting violations; a designated employee, officer, or director tasked with administering the policy and reporting to the audit committee or other committee of independent directors or, if there are no such committees, to the board; and a requirement that the policy is distributed to all directors, officers, employees, and volunteers.

Required Audit Procedures and Financial Reporting

Audit Committee and New Audit Procedures

One of the more significant changes in the Act relates to financial audits, including audit committees, governance procedures, and financial reporting to the Attorney General. The audit provisions apply not just to nonprofits incorporated in New York, but also to nonprofit organizations incorporated anywhere that are required to register under New York Executive Law Section 172 – the charitable solicitation registration statute – due to their charitable solicitation activities in New York.

The Act requires all organizations subject to registration for charitable solicitation in New York that are required to file an independent auditor's report with the Attorney General, pursuant to Section 172-b of the New York Executive Law (triggered by receipt of gross revenues above $500,000 in 2014; $750,000 in 2017; and $1,000,000 in 2021, as further explained below), to have a designated audit committee of the board comprised of independent directors responsible for retaining an independent auditor and reviewing the results of the audit. Alternatively, the delineated tasks must be performed by the independent directors on the board.

The audit committee of an organization with annual revenues (presumably meaning gross revenues) in excess of $1,000,000 that is required to file an independent certified public accountant's audit report with the Attorney General, pursuant to Section 172-b of the New York Executive Law, is subject to more extensive duties relating to the audit, including reviewing the scope and planning of the audit with the auditor prior to commencement of the audit, discussing any significant disagreements between the auditor and management after the audit, and annually considering the performance and independence of the independent auditor.

The audit committee also is charged with overseeing adoption, implementation, and compliance with the mandatory conflict of interest and whistleblower policies.

Raised Thresholds for Financial Reports

The Act raises the thresholds of revenues for which organizations conducting charitable solicitations in New York are required to file certain financial reports with the Attorney General. These threshold levels will become progressively higher on July 1, 2014; July 1, 2017; and July 1, 2021, respectively. Starting on July 1, 2014, organizations with gross revenues under $250,000 (previously $100,000) may file unaudited financial statements signed by the chief financial officer and president, or other authorized officer, under penalties of perjury. Organizations with gross revenues greater than $250,000 (previously $100,000) but less than $500,000 (previously $250,000) must file annual financial reports accompanied by an independent certified accountant's review report in accordance with "statements on standards for accounting and review services" issued by the American Institute of Certified Public Accountants. Organizations with gross revenues greater than $500,000 (previously $250,000) must file annual financial statements accompanied by an independent certified public accountant's audit report with an opinion that the financial statement and balance sheet fairly present the financial operations and position of the organization.

In 2017, these threshold levels are raised so that organizations with gross revenues under $250,000 will still file unaudited financial statements, but organizations with gross revenues between $250,000 and $750,000 must file annual financial statements with a CPA's review report, and organizations with gross revenues over $750,000 must filed annual financial statements with certified audit reports. In 2021, the threshold is increased to allow organizations with gross revenues between $250,000 and $1,000,000 to file annual financial statements with review reports and organizations with gross revenues over $1,000,000 to file annual financial statements with certified audit reports.

Interestingly, if the Attorney General is unsatisfied with the statements that are filed with a review report, the Attorney General can require an organization to have its financial statements audited; even if the organization's gross revenue is below the threshold limit. This could be an expensive endeavor for smaller organizations.

The requirement to file different types of financial reports is not new, and the three-step increase in revenue thresholds should relieve the burdens of filing audited financial statements or financial statements with review reports for some smaller nonprofits. However, the mandatory audit procedures and designated audit committee functions go well beyond what was previously required under New York law and are detailed in a nature that goes well beyond that of other states' requirements in the charitable solicitation area.

Simplification of Approval Process for Certain Transactions

Ability to Seek Consent of Attorney General as Opposed to New York Supreme Court for Certain Corporate Transactions

The Not-for-Profit Corporation Law previously required Type B, C, and D organizations to engage in a two-step process of 1) seeking approval of the New York Supreme Court, and 2) providing notice to the New York Attorney General, prior to engaging in certain fundamental transactions. The Act now provides a simplified process for "charitable" entities, whereby the organization can seek the approval of the Attorney General instead of initiating a court proceeding for transactions such as dissolution (sale, lease, exchange, or other disposition of substantially all assets); merger or consolidation; and change of purposes. The Attorney General has discretion whether to grant such action or to require the action to be submitted for the approval of the New York Supreme Court, and the nonprofit can appeal a denial by the Attorney General to the New York Supreme Court. The process for approval of non-charitable entities remains the same as under current law.

Notification Instead of Consent to New York Commissioner of Education

The Act also modifies a prior requirement for certain organizations with an educational purpose as defined by the New York Education Law (i.e., "colleges, universities, or other entities providing post-secondary education; nursery, elementary, secondary or charter schools; libraries, archives, or museums or historical societies with collections; and public television and radio shows") to seek the approval of the New York Commissioner of Education prior to incorporation. Under the new Act, out of the types of entities listed above, those that do not have as one of their purposes the operation of a "school, university, library, museum, or historical society" no longer have to receive prior approval.

Lowered Approval Requirements for Real Property Transactions

Previously, the New York Not-for-Profit Corporation Law required that two-thirds of the entire board approve any purchase of real property, for organizations with fewer than 21 directors. The Act lowers this threshold by requiring that only a simple majority of the board needs to authorize the purchase, sale, lease, exchange, or other disposition of real property, provided that the property to be acquired or disposed of does not constitute all, or substantially all, of the assets of the corporation. If the property does constitute all, or substantially all, of the corporation's assets, the approval of two-thirds of the entire board will continue to be required (unless there are 21 or more board members, in which case simple majority approval is sufficient). The Act also allows for the final determination as to the purchase, sale, lease, exchange, or other disposition of real property to be delegated to a committee authorized by the board, provided that the committee report any actions taken to the board by the next regularly scheduled board meeting.

Other

New Definition of "Entire Board"

The Act includes a new definition for the term "entire board" that clears up an ambiguity in the previous definition regarding the number of directors that must be counted for purposes of a quorum and board action when board size is provided as a range in the bylaws. Under the Act's new definition, if the board size is provided as a range between a minimum and maximum number, any reference to the "entire board" shall refer to the number of directors elected as of the most recent election. Meeting the "entire board" voting thresholds could be difficult for a board with vacant seats if there is a set number of directors provided for in the bylaws.

Removal of Requirement to Provide Residential Addresses of Board Members

The Act eliminates a provision in the section on membership access to records that required the corporation to provide the residential address of board members and officers to members upon request. Under the Act, a corporation may lawfully comply with a member request by providing a list of board members and officers without addresses.

Conclusion

The New York Nonprofit Revitalization Act will modernize the laws applicable to nonprofits incorporated in New York and enhance nonprofit governance and oversight. It also will establish new restrictions and requirements in the governance area that will require certain nonprofits to make significant – and, in some cases, challenging – changes to their governance structure. Notably, the financial audit provisions apply to all nonprofits required to register to solicit New York residents for charitable contributions, regardless of their state of incorporation. Presuming the Act is signed into law – which most expect it will be – many New York nonprofit corporations will need to adopt additional policies and procedures, and should carefully review their governance documents for compliance with the new law.

- The New York Nonprofit Revitalization Act, as passed by the New York legislature, is available at: http://assembly.state.ny.us/leg/?default_fld=&bn=A08072&term=&Summary=Y&Actions=Y&Text=Y.
- The New York Nonprofit Revitalization Group Report, on which much of the new law is based, is available at: http://www.ag.ny.gov/sites/default/files/press-releases/2012/NP%20Leadership%20Committee%20Report%20(2-16-12).pdf.

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