November 2016 Amendments to the Not-For-Profit Corporation Law

By Fred Attea

The Nonprofit Revitalization Act of 2013 ("NPRA") created numerous operational difficulties for New York nonprofit corporations, especially as it relates to corporate governance. The definition of "Independent Director," which was new to the Not-For-Profit Corporation Law (N-PCL), had an adverse effect, especially in smaller communities, because it effectively removed from the potential panel of independent directors many persons who were employed by large institutions that were doing routine business with the nonprofit.

The NPRA's definition of "Related Party Transaction" created confusion and interpretive difficulties because the definition had no materiality standard. Literally, a director of a hospital whose grandchild is to be treated in the hospital is involved in a "related party transaction" and technically is required to obtain Board approval in advance of the treatment. All related party transactions required approval by the audit committee or other committee of independent directors. The net result was that New York not-for profits were literally subjected to requirements totally out of proportion with the wrongs to be righted.

The problems generated by the NPRA were of such concern to the nonprofit community that remedial legislation was advocated by many constituencies.

As a result of coordinated efforts by the Lawyers Alliance for New York, the New York State Bar Association, the New York City Bar Association, the New York State Law Revision Commission and the Non-Profit Coordinating Committee of New York, legislation was approved by the New York State Legislature on June 16, 2016 and signed into law by Governor Cuomo on November 28, 2016. The legislation amended a number of provisions of the N-PCL introduced by the NPRA. To a great extent, these provisions address some of the unanticipated and pragmatic problems created by the corporate governance provisions of the NPRA. The legislation also included comparable amendments to parallel provisions of the Estates, Powers and Trusts Law.

Key Person

These amendments also introduce a new definition, "key person," (N-PCL Section 102(a)(25)), which replaces the definition of "key employee." A "key person" is defined as any person who is neither a director nor officer but who has:

> . . . responsibilities, or exercises powers or influence over the corporation as a whole similar to the responsibilities, powers, or influence of directors and officers … [or who] … manages the corporation, or a segment of the corporation that represents a substantial portion of the activities, assets, income or expenses of the corporation; or … [who] . . . alone or with others controls or determines a substantial portion of the corporation's capital expenditures or operating budget.

This concept is a response to concerns over persons who exercise a controlling influence, as was the case in the infamous Soundview Health Center litigation where former State Senator Pedro Espada Jr. was convicted in federal court in 2012 for theft of funds from a charitable organization that he founded. The difficulty in prior state and federal investigations was that Mr. Espada was not subject to the N-PCL restraints because he was not an employee, officer or director of the organization. This new definition, although broad in scope, was carefully crafted so that supporting philanthropists who are not using their position to affect the management of the nonprofit corporation will not be considered key persons.

Independent Directors

The NPRA's previous definition of "independent director" in N-PCL Section 102(a)(21) excluded a person who (among other things) was:

> a current employee of, or …[had] … a substantial financial interest in, … [or who] … had a relative who … [was] … a current officer of or … [has] … a substantial financial interest in, any entity that … [in any of the last three years] … made payments to, or received payments from, … [the non-profit corporation in excess of] . . . the lesser of twenty-five thousand dollars or two percent of the entity's consolidated gross revenues.

Many nonprofits found this definition too stringent, adversely affecting their ability to recruit the needed number of independent board members. To alleviate the

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situation, the 2016 amendments introduced a scale of materiality by changing the standard for independence to exclude a person who

> … is not a current employee of or does not have a substantial financial interest in, and does not have a relative who is a current officer of or has a substantial financial interest in, any entity that has made payments to, or received payments from, the corporation or an affiliate of the corporation for property or services in an amount which, in any of the last three fiscal years, exceeds the lesser of twenty-five thousand dollars or two percent of such entity's consolidated gross revenues.

This amendment sets a lower barrier initially (i.e., $10,000 vs. $25,000), but the number of levels in the new materiality scale should provide some needed flexibility in order to allow a director to be independent even though he or she is employed by a bank, insurance company, utility or similar entity. In such cases, the board member's judgment would not reasonably be expected to be tainted by the relationship because the financial impact to the employing entity is minimal. This may be especially helpful in smaller communities where finding skilled directors would be difficult if all employees of large local employers are excluded from being independent directors.

Furthermore, "payment" does not include, among other things:

> … payments made by the corporations at fixed or non-negotiable rates or amounts for services received . . . [and that] …are available to individual members of the public on the same terms and such services received by the corporation are not available from another source.

This latter situation might be applicable to payments to utilities that have exclusive territories but does not seem to offer much additional relief.

Related Party Transactions

Perhaps some of the most significant and needed changes in the N-PCL are those changes made to the "related party transaction" definition in N-PCL Section 102(a)(24), which now excludes a transaction where:

> … (i) the transaction or the related party's financial interest in the transaction is de minimis, (ii) the transaction would not customarily be reviewed by the board or boards of similar organizations in the ordinary course of business and is available to others on the same or similar terms, or (iii) the transaction constitutes a benefit provided to a related party solely as a member of a class of the beneficiaries that the corporation intends to benefit as part of the accomplishment of its mission which benefit is available to all similarly situated members of the same class on the same terms.

This exclusion is similar to the Charities Bureau's guidance on Conflicts of Interest issued on April 24, 2015, and cures a problem of extreme concern to the not-for-profit community.

Eliminating de minimis transactions and those transactions that are not normally addressed by the board in the ordinary course of business from the "related party transaction" definition will rationalize the process of dealing with related party transactions. The change also eliminates routine situations which literally fell into the related party definition in the NPRA. This directly impacts concerns of board members of institutions involved in health care and education where a director or his or her family members utilize the services of such corporations.

Another relaxation of the related party transaction requirements is the provision of a defense to challenges by a third party (other than the Attorney General) that a related party transaction should be nullified because it was not properly approved under Section 715(a) or (b) of the N-PCL. The defense is that the transaction was fair and reasonable and in the corporation's best interests when it was approved by the corporation.

Because of the concern that related party transactions, due to the breadth of the previous definition, can inadvertently occur without following the procedures set out in N-PCL Section 715(a) and (b), the legislature opted to include a method to effectively ratify later-discovered transactions and thus provide a defense to a claim by the Attorney General provided that:

> … (1) the transaction was fair, reasonable and in the corporation's best interest at the time the corporation approved the transaction and (2) prior to receipt of any request for information by the attorney general regarding the transaction, the board has: (A) ratified the transaction by finding in good faith that it was fair, reasonable and in the corporation's best interest at the time the corporation approved the transaction; and, with respect to any related party transaction involving a charitable corporation and in which a related party has a substantial financial interest, considered alternative

> transactions to the extent available, approving the transaction by not less than a majority vote of the directors or committee members present at the meeting; (B) documented in writing the nature of the violation and the basis for the board's or committee's ratification of the transaction; and (C) put into place procedures to ensure that the corporation complies with paragraphs (a) and (b) of this section as to related party transactions in the future.

Executive Committee

The amendments also change Section 712 of the N-PCL to allow a board of directors' appointment of members to a committee of the board to be made by the typical majority vote at a meeting at which there is a quorum, instead of by a majority of the entire board. The requirement of approval by a majority of the entire board is retained for the executive committee. There is, however, a recognition that corporations with large boards of directors (30 or more members) may have difficulty in obtaining the vote of the majority of an entire board and, in such situations, the corporation may appoint members to an executive committee by a vote of three-quarters of the members of the board at a meeting at which a quorum is present.

The Section 712 list of actions that cannot be delegated to an executive (or other) committee has been expanded to include:

> … (6) the election or removal of officers and directors.
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> (7) The approval of a merger or plan of dissolution.
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> (8) The adoption of a resolution recommending to the members action on the sale, lease, exchange or other disposition of all or substantially all the assets of a corporation or, if there are no members entitled to vote, the authorization of such transaction [and]
>
> (9) The approval of amendments to the certificate of incorporation.

This is not a change in existing law but an attempt to bring together in one section all of the N-PCL's provisions that prohibit delegation of powers to an executive committee.

Conflicts of Interest and Whistleblower Policies

The amendments specify that it is the board, not merely someone acting on behalf of the corporation, that must adopt procedures for addressing conflicts of interest and whistleblower complaints. The amendments also remove the requirement that only independent directors may oversee implementation of, and compliance with, both policies. Prior to the 2016 Amendment, N-PCL Section 715(b) required the whistleblower policy be administered by the audit committee or a committee consisting solely of independent directors or, if no such committees existed, by the board. The amendments now permit administration of these policies by the board or any board committee (although in the case of the whistleblower policy, employees may not participate).

Employee as Board Chair

The NPRA Amendments ameliorate a problem that was set to begin January 1, 2017, when a provision of the original NPRA would have barred any employee of the corporation from serving as board chair (or the equivalent position). Under the amendments, an employee may serve in such a position upon approval by two-thirds of the entire board with a documentation of the basis for the approval, though that person cannot be considered an independent director. This amendment provides a solution for a serious governance issue that would have been presented for hundreds, possibly thousands, of nonprofits, such as churches whose ecclesiastical governing laws require the pastor to chair the church trustee board.

Miscellaneous

A provision in N-PCL Section 712(e) that purported to make non-board members on committees subject to the N-PCL provisions applicable to officers generally was deleted. This will eliminate the implication that volunteers are subject to the liabilities of officers when serving on committees of the corporation. In addition, N-PCL Section 712(a) will allow the by-laws to provide that the holders of certain positions have automatic placement as ex officio nonvoting members of specific committees.

Future Considerations

While there has been concern that the amendments do not go far enough, there is little doubt that they will remove some of the most vexatious problems created by the NPRA. There is also a realization among practitioners that there are many other areas of the N-PCL that could use updating and changes to bring them into conformity with what is considered to be good corporate practice.

A failure to continue the process that led to the 2016 NPRA Amendments could accelerate the tendency of New York-based not-for-profits to incorporate in other states.