June 18, 2014

Changes to New York Nonprofit Governance Law Effective July 1, 2014

On July 1, 2014, certain substantial changes to New York nonprofit law will take effect, and will require compliance by all nonprofit organizations incorporated in New York, as well as certain nonprofit organizations doing business or soliciting donations in New York even if incorporated elsewhere.

The New York Nonprofit Revitalization Act of 2013 (the "Act") represents the most significant update to New York's nonprofit laws in 40 years, and is intended to enhance nonprofit governance and oversight to prevent fraud and improve public trust, as well as to reduce unnecessary and outdated burdens on nonprofit organizations. As summarized in this memorandum, the Act requires all nonprofit organizations to review existing governing documents, policies and internal controls.

Actions Required by July 1, 2014

The following summary outlines the steps all New York nonprofit organizations (and, where indicated, certain nonprofits incorporated elsewhere) should take to ensure compliance as of July 1, 2014:

- *Adoption or Amendment of Conflicts of Interest Policy*. Every nonprofit organization incorporated in New York must have in place as of July 1, 2014 a Conflicts of Interest Policy including, at a *minimum*:
    - A definition of situations that constitute conflicts of interest;
    - Procedures for disclosing conflicts to the audit committee or the board;
    - A requirement that the person with the conflict not be present at, or participate in, deliberation or voting on the matter presenting a conflict;
    - A prohibition against attempts by the person with the conflict to improperly influence deliberation or voting on the matter presenting a conflict;
    - A requirement that the existence and resolution of the conflict, along with the minutes of any meeting at which it is discussed, be documented in the organization's records; and
    - Procedures for disclosing, addressing, and documenting related party transactions.

  The Act provides that organizations that have adopted a Conflicts of Interest Policy as required by federal, state or local law that is substantially consistent with the Act's requirements will be

deemed in compliance with the Act. Note, however, that even existing policies drafted based on the IRS sample should be reviewed for compliance with the Act.

- *Related Party Transactions; Compensation*. In addition to the above, other substantive provisions of the Act relate to conflicts of interest and fairness in compensation practices. It is best practice to include the following provisions in your organization's Conflicts of Interest Policy, or otherwise in the by-laws or appropriate committee charter, to ensure compliance:
    - Related Party Transactions: Procedures and Related Definitions.
        - Under the Act, a "related party transaction" is "any transaction, agreement or any other arrangement in which a related party has a financial interest and in which the organization or any affiliate of the organization is a participant."
            - A "related party" is defined as:
                - Any director, officer or key employee of the organization or of any affiliate of the organization;
                - Any relative of any director, officer or key employee of the organization or of any affiliate of the organization; or
                - Any entity in which any of the above individuals has at least 35% ownership or beneficial interest, or in the case of a partnership or professional organization, a direct or indirect ownership interest in excess of 5%.
            - With respect to any individual, the Act defines "relative" as such individual's spouse, ancestors, brothers and sisters (whether whole or half blood), children (whether natural or adopted), grandchildren, great-grandchildren, and spouses of brothers, sisters, children, grandchildren, and great-grandchildren; or such individual's domestic partner as defined under New York law.
        - A nonprofit organization must take the following affirmative steps before any "related party transaction" may be completed:
            - Any director, officer, or key employee who has a financial interest must disclose to the board or authorized committee the facts relating to that interest and may not participate in deliberations and voting on the transaction;

- The board or authorized committee must determine that the transaction is fair, reasonable, and in the best interest of the organization; and
- If a related party has a substantial financial interest, the board or authorized committee must (1) prior to entering into the transaction, consider alternative transactions to the extent available; (2) approve the transaction by not less than a majority vote of the directors or committee members present at the meeting; and (3) contemporaneously document in writing the basis for the board or authorized committee's approval, including its consideration of any alternative transactions.

- Compensation of Directors, Officers or Members. As is the case under the current law, under the Act an organization may pay reasonable compensation to members, directors, or officers. However, the Act further provides that no person who may benefit from a given compensation policy may be present at, or participate in, deliberation or voting on such compensation. The potential beneficiary may still present information, or answer questions, at the request of the board, but this must occur prior to deliberation and voting.

- Prohibition of Employees Serving as Board Chair. Effective as of January 1, 2015, the Act will bar any employee of the organization from serving as chair of the board or holding a title with similar responsibilities.

➢ *Adoption or Amendment of Whistleblower Policy*. Nonprofit organizations incorporated in New York, having 20 or more employees and annual revenue of at least $1 million (as measured by the prior fiscal year), must adopt a whistleblower policy or amend any existing policy to comply with the requirements listed below. The whistleblower policy must include:

- Procedures for the reporting of violations or suspected violations of laws or corporate policies, including procedures for preserving the confidentiality of reported information;
- A requirement that an employee, officer, or director of the organization be designated to administer the whistleblower policy and to report to the audit committee or other committee of independent directors or, if there are no such committees, to the board; and
- A requirement that a copy of the policy be distributed to all directors, officers, and employees, and to volunteers who provide substantial services to the organization.

➢ *Review and Amendment of By-laws*. The Act eliminates the distinction between "standing" and "special" committees of the board. Instead, all board committees will be standing committees, to which the board may delegate all or part of its authority, and on which only voting members of

the board may serve. Committees of the corporation, on which non-board members may serve, may not be delegated any board powers, or the authority to bind the board.

All references to "special committees" should be removed from by-laws, such that the only permitted committees are (1) standing committees of the board and (2) committees of the corporation. We note that this change prohibits organizations from delegating certain responsibilities to advisory committees or other non-voting members of the board, and recommend that organizations review their committee structure to ensure compliance.

- *Audit Oversight Requirements*. Under both current law and the Act, organizations with a certain minimum revenue generated in New York that are registered to solicit contributions from the public are required to file audited financial statements with the New York Attorney General, whether incorporated in New York or elsewhere (such requirements generally will not apply to private foundations). The Act introduces specific oversight functions that must be performed by the board or a committee of the board with respect to the organization's financial audit.
    - Audit Function: The audit oversight functions of the board/committee must include:
        - Overseeing the accounting and financial reporting processes of the corporation and the audit of the corporation's financial statements;
        - Retaining an independent auditor to conduct the audit and reviewing the results;
        - Overseeing the implementation of, and compliance with, any conflict of interest or whistleblower policy, unless that function is performed by another committee of independent directors of the board; and
        - If an organization expects to have annual revenue over $1 million, the board or audit committee must also perform the following functions:
            - Review with the independent auditor the scope and planning of the audit prior to the commencement of the audit;
            - Upon completion of the audit, review and discuss with the independent auditor (1) any material risks and weaknesses in internal controls identified by the auditor, (2) any restrictions on the scope of the auditor's activities or access to requested information, (3) any significant disagreements between the auditor and management, and (4) the adequacy of the applicable charitable corporation or charitable trust's accounting and financial reporting processes;

- Annually consider the performance and independence of the independent auditor; and
- If the audit function is performed by a committee, report on the audit committee's activities to the board.

We recommend that the above requirements be reflected in the by-laws or audit committee charter.

- Independent Directors. The independent directors on the board, or an audit committee comprised solely of independent directors on the board, must perform the audit oversight function. An "independent director" is a director who:
  - In the past three years, has not been an employee or relative of an employee of the organization or its affiliates;
  - In the last three years, has not received, and does not have a relative who has received, more than $10,000 in direct compensation from the organization or its affiliates; and
  - 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 (other than charitable contributions) to, or received payments (other than charitable contributions) from, the nonprofit corporation or charitable trust or an affiliate thereof, for property or services in an amount that exceeds the lesser of $25,000 or 2% of such entity's consolidated gross revenue in any of the last three fiscal years.

We recommend that the above qualifications for "independent directors" be reflected in the by-laws or audit committee charter.

Additional Provisions of the Act Reducing Certain Governance Requirements

- Elimination of Type Classification. Under the Act, the "Type" classification system designating nonprofits as "Type A," "Type B," "Type C" or "Type D" corporations has been eliminated. In its place, nonprofit organizations will be classified only as "charitable" or "non-charitable" corporations.
  - Existing organizations do not need to take any action to reflect this automatic change. Most 501(c)(3) organizations will be reclassified as "charitable corporations," while most non-501(c)(3) organizations will be deemed "non-charitable corporations."

- Nonprofits formed after July 1, 2014 need not specify a "Type" in the certificate of incorporation.

- Increased Revenue Thresholds for Audit Requirement. Currently, organizations with annual revenue in excess of $250,000 must submit audited financial statements to the New York Attorney General along with their annual reports. The Act will raise this minimum revenue threshold to $500,000 in 2014, and again in additional increments in subsequent years, thus eliminating the financial audit requirement for certain smaller organizations. The Act will similarly raise the revenue thresholds applicable to other financial reporting requirements .

- Electronic Communications. Beginning July 1, 2014, notice of member and director meetings, waiver of notice, and written consent to board action without a meeting may be delivered via fax or email.

- Streamlined Procedures for Significant Transactions. The Act will permit organizations to obtain approval for dissolution, mergers and certain asset sales directly from the New York Attorney General, in lieu of the more onerous court approval process required under current law.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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