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Expert Analysis

Nonprofit Revitalization Act One Year Later

One year has passed since the Nonprofit Revitalization Act, the most sweeping reform of New York's nonprofit laws in decades, took effect, and the early indicators are positive. Nonprofits are adapting to the new statute, implementing necessary governance reforms while benefiting from a more streamlined and modernized regulatory framework. Helpful guidance from the Attorney General's Charities Bureau and some recent amendments, passed but not yet signed into law, will further aid the transition. But the real test is still to come: Will the cultural change within boardrooms that the new law was intended to prompt be realized?

The Nonprofit Revitalization Act seeks to transform the traditional nonprofit governance paradigm. Deferential and passive nonprofit boards no longer comport with evolving expectations of fiduciary responsibility. Increasingly, donors, regulators, the media and the public expect that nonprofit boards are actively engaged in overseeing funds and assets entrusted on their watch. The Madoff fraud, the fiscal crises and the numerous scandals splashed across the front pages in recent years highlight not just the importance of board oversight but the often profound consequences of failing to provide it. The lesson learned is that nonprofit boards must be positioned to spot issues before they turn into problems—to spot the yellow flags before they turn red. Because once the flag turns red, it is often too late.

While the New York Attorney General's Office has recently stepped up enforcement efforts—with particular focus on fiduciary responsibilities of boards—the Nonprofit Revitalization Act reflects the reality that enforcement alone does not ensure good governance. Rather, good governance results from people—particularly board members—who are aware of their responsibilities and are positioned to carry them out.

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By
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At its core, the act seeks to strengthen board oversight in the areas that traditionally create the most legal risk and exposure: conflicts of interest, self-dealing, and audit and fiscal oversight. If one surveys why nonprofits fail or get into trouble, typically it is caused by deficiencies in one or more of these areas. In most cases, directors are operating with good intentions and trying to do the right thing, but often are unaware of the steps needed to ensure compliance with their fiduciary duties. The act attempts to help directors avoid those pitfalls by providing a road map to guide them.

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Related Party Transactions

No issue historically has generated more attention from regulators, and more confusion and anxiety within boardrooms, than insider transactions. Virtually every major nonprofit scandal in recent memory stemmed from individuals who leveraged their relationship with a nonprofit to achieve financial gain. The Nonprofit Revitalization Act aims to protect nonprofits from entering into improper "related party transactions," broadly defined as transactions in which the nonprofit or an affiliate of the nonprofit is a participant and in which a director, officer, or key employee (or relative) has a financial interest, either directly or through ownership in an outside entity.

Significantly, the act does not ban "related party transactions," recognizing that at times the benefit to nonprofits may significantly outweigh the benefit to insiders. Rather, the act sets forth a process for the proper board review of the transactions.

The key statutory change, codified in Section 715 of the Not-for-Profit Corporation Law and Section 8-1.9 of the Estates, Powers & Trusts Law, is the requirement that boards (or board committees) of all not-for-profit corporations, and trustees of wholly charitable trusts, affirmatively determine that a related party transaction is fair, reasonable, and in the best interest of the organization prior to entering into the transaction.

Transactions involving charitable corporations and trusts are subject to additional review. Section 715 provides that any related party transaction in which a related party has a substantial financial interest must engage in a three-step process prior to entering into the transaction. The board or a board committee (or trustees): (1) must evaluate alternative transactions, to the extent they are available, (2) approve the transaction by a majority vote without the insider's participation, and (3) contemporaneously document the basis for its decisions.

Disclosure of the transaction is required, but disclosure alone will not protect the transaction from challenge or scrutiny by the New York State Attorney General. Similarly, an ultimate determination that the terms are fair to the organization will not itself insulate the transaction. The latter has caused some to criticize the statute as too harsh, as it may lead the Attorney General to bring enforcement actions based on procedural or technical deficiencies, not on whether a harm resulted from the transaction.

Though it is unlikely the Attorney General would use its resources so unwisely, board members should be reminded of the statute's overarching objective—encouraging active board oversight in high risk areas. In this regard, process—and not necessarily outcome—is what matters.

Some organizations, particularly those with complex organizational structures and many affiliates, have found aspects of the statute challenging to administer. For example, some organizations initially were concerned that board review could be required for de minimis transactions or for certain ordinary course transactions that common sense dictates should not warrant board review.

This spring, the Attorney General's Charities Bureau issued guidance (available at www.charitiesnys.com) intended to address these concerns. The guidance provides a general framework for evaluating related party transactions and identifies specific examples of de minimis and ordinary course and transactions that the Charities Bureau believes could be exempted from the statutorily mandated review. Though the guidance does not have the effect of law, it serves as the functional equivalent given that the Attorney General is charged with enforcing the act.

Further clarifying the provisions, the New York State Legislature adopted amendments in June 2015 (S5868A-2015 and S5870-2015, awaiting Governor Andrew Cuomo's signature). Although many of the amendments are technical in nature, one key change narrows the definition of "affiliate," which under current law means entities "controlled by, in control of, or under common control" with the nonprofit.

This last part—under common control—has created practical concerns for complex organizations, such as hospital and university systems, as well as corporate foundations. These entities may be deemed to have numerous "affiliates" under the broad definition, including many with which the organization has no involvement or knowledge, making compliance with related party transaction requirements impractical or illogical. To address this concern, the June 2015 amendments delete "under common control" from the definition.

Financial Audit Oversight

Viewing the Nonprofit Revitalization Act through the lens of active board engagement, it becomes clear why the legislation imposes new audit oversight and independence requirements.

The independent financial audit is arguably the most important mechanism ensuring proper checks and balances in the governance of nonprofit organizations. Historically, however, at many organizations the relationship between the outside auditor and the organization had resided not at the board level but with management. Thus, too often, the auditor felt accountable not to the board but to management and communicated results of audit findings to the board through management, if shared with the board at all.

The Nonprofit Revitalization Act recognizes that if a board is to provide meaningful fiscal and risk oversight, it must be in direct contact with the outside auditor, and the auditor must understand that it is ultimately responsible to the board. The act, therefore, requires that the board or a designated audit committee of the board perform, at a minimum, two tasks: retaining the outside auditor at the outset of the audit and reviewing the audit's findings with the auditor upon completion. Larger organizations—those with annual revenue of more than $1 million—must engage in additional oversight responsibilities, such as discussing with the auditor weaknesses in internal controls and the adequacy of accounting and financial reporting processes.

Only independent directors (as defined in the statute) can participate in discussions or voting concerning audit oversight matters. Despite calls that the definition of independent directors is too strict and should be relaxed, the Legislature has demurred, apparently in recognition of the critical role the financial audit plays in protecting charitable funds, particularly at state-supported organizations. In fact, the June 2015 amendments to the act actually expanded the definition to cover relationships between directors and outside auditors.

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Notably, the audit oversight requirements only apply to organizations that are required to obtain an independent financial audit under Article 7-A of New York's Executive Law. Generally, organizations are required to obtain audits if they raise funds publicly or through government grants, and have revenues above $500,000. Thus, these rules would not apply to most non-charitable organizations, such as trade associations, as well as most private foundations, which generally do not fundraise publicly. Nor would they apply to organizations that are exempt from registration with the Charities Bureau under Article 7-A of the Executive Law, such as religious corporations.

Mandated Policies

The Nonprofit Revitalization Act requires that nonprofit organizations adopt the two policies that experience shows are critical to identifying and addressing financial and legal risks: conflict of interest policies and whistleblower policies.

Conflict of Interest Policies. All not-for-profit corporations and wholly charitable trusts must now have a written conflict of interest policy. There are no exceptions; all trade associations, religious corporations, education corporations, and other organizations that may otherwise be exempt from registration with the Charities Bureau must comply. The Act requires conflict policies to include specified provisions, including procedures for disclosing conflicts to the board or audit committee (or other committee of independent directors) and procedures for disclosing, addressing and documenting related party transactions and a requirement that directors and trustees complete conflict of interest disclosure statements, initially prior to their election and annually thereafter. It is important to note that many organizations may have based their prior policies on a sample policy posted on the Internal Revenue Service's website; however, that policy does not meet the requirements imposed by the Nonprofit Revitalization Act.

Whistleblower Policies. Though often ignored in the nonprofit governance literature, whistleblower policies are an enormously beneficial oversight tool. When they work effectively, whistleblower policies can prevent organizations from violating the law, or help them address violations more quickly, limiting the legal, financial and reputational harm that could result. All not-for-profit corporations and wholly charitable trusts that have 20 or more employees and annual revenue exceeding $1 million must have a whistleblower policy and implement procedures for directors, trustees, officers, employees, and volunteers to report potential illegality and protect whistleblowers from retaliation.

Board Committees

One clarification contained in the act has generated more conversation than expected. The act reaffirmed the pre-existing requirement in Section 712 of the Not-For-Profit Corporation Law that board committees must be comprised only of directors. The act left unchanged the provision that committees must consist "of three or more directors" and added that committees of the corporation—which are non-board committees that serve in an advisory capacity—do not have "authority to bind the corporation."

Although this provision did not change prior law, it appears that some organizations had honored it only in the breach and routinely placed non-board members on certain committees, particularly the audit committee. Despite calls to soften this requirement, the Legislature has declined, apparently endorsing the Attorney General's historic view that board decision-making should rest exclusively in individuals who have clear fiduciary obligations to the organization and who have a formally defined statutory role.

Conclusion

The first year anniversary of the Nonprofit Revitalization Act provides a good opportunity for nonprofit boards to assess how well their new policies and procedures are working. Time will tell whether the legislative objective of encouraging more active engagement by boards is achieved. In any event, the fact that bylaws are being dusted off, new policies adopted, and governance practices examined can only have a positive effect and help maintain the public's trust that nonprofits and their assets are in good hands.