Major Reforms for New York Nonprofits Signed Into Law

On December 18, 2013, almost six months after the Non-Profit Revitalization Act of 2013 (the "Act") passed the New York State Legislature, New York Governor Andrew Cuomo signed the Act into law. The Act amends the patchwork of requirements applicable to domestic and foreign nonprofits that conduct activities in New York. Major changes include new governance rules, streamlined administrative and procedural filing requirements and expanded state oversight power.

This alert summarizes the most significant changes that nonprofits, including those operating in the health care sector, should consider between now and the Act's July 1, 2014 effective date.

Background

In July 2011, following a number of high-profile news stories involving nonprofits, Attorney General Eric Schneiderman convened the Leadership Committee for Nonprofit Revitalization. The Leadership Committee, composed of representatives of the nonprofit sector and nonprofit legal practitioners, developed proposals to reduce burdens on the nonprofit sector while strengthening governance, oversight and accountability. The Act incorporated many of the Leadership Committee's recommendations, and passed both houses of the New York State Legislature in June 2013.

Key Reforms

Related Party Transaction Approval Process

Under the Act, a nonprofit's governing board is prohibited from entering into a "related party" transaction unless it has determined that the transaction is fair, reasonable and in the nonprofit's best interests. Under the Act, a "related party" is defined as any director, officer or key employee of the organization or an affiliate; any relative of such individual; and any entity in which such individual has a 35% or greater ownership interest or, in the case of a partnership or professional corporation, a greater than 5% direct or indirect ownership interest. This definition of "related party" draws heavily from two IRS sources that do not integrate particularly well – the definition of a "disqualified person" for purposes of the "intermediate sanctions" penalty excise tax on excessive payments to charity insiders and the definition of an "interested person" for purposes of reporting certain transactions on IRS Form 990. The Act also dictates the review and approval process that boards must undertake before entering into a related party transaction, and specifically empowers the Attorney General to challenge a related party transaction. In the case of willful and intentional misconduct, the Attorney General may impose a penalty on the nonprofit or its directors of twice the improperly obtained benefit, in addition to other statutory remedies.

Organizations should be aware that the "related party" definition under the Act differs from other state definitions addressing related party relationships applicable to some nonprofit organizations, especially in the health care sector. For example, the definition of "related organization" under state rules regarding cost reporting for medical facilities and under Executive Order 38 (which places limits on compensation for executives of state-funded nonprofits) differs significantly from the definition of "related party" under the Act.

Executive Compensation Approval Process

The Act imposes specific, albeit somewhat limited, procedural requirements on boards of nonprofits in their

review of executive compensation packages. Specifically, the Act restricts persons who may benefit from compensation paid by the nonprofit from participating in any board or committee deliberation or vote concerning the compensation, except to the extent the board or committee requests that they present information or answer questions. These procedural requirements are less specific than those necessary to establish a "rebuttable presumption" of reasonableness under the federal intermediate sanctions rules noted above. Directors who vote for, or concur in, a compensation arrangement without following these procedural requirements may be jointly and severally liable to the organization under existing statutory provisions. In addition, the Act helps to clarify the process entailed for board approval of executive compensation packages, which is also a requirement of Executive Order 38 for state-funded nonprofits that seek to pay certain executives in excess of $199,000 per year.

Whistleblower and Conflict of Interest Policy Requirements

Under the Act, nonprofits with over $1 million in annual revenues and 20 or more employees must adopt a whistleblower policy to protect against retaliation persons who report suspected improper conduct.

Nonprofits that have already developed a whistleblower policy to comply with another federal, state, or local law that is substantially consistent with the Act's provisions, such as the False Claims Act or the New York State Office of the Medicaid Inspector General's mandatory compliance program requirements, will likely be in compliance with the Act because of overlap in policy requirements. When developing or revising their whistleblower policies, nonprofits in the health care sector must also consider unique provisions of the New York State Labor Law, which provide for whistleblower protections for reporting improper quality of care.

The Act also requires that all nonprofits adopt a conflict of interest policy that requires directors, officers and key employees to act in the organization's best interests. The Act specifies minimum required components of the policy, but acknowledges that nonprofits may have already adopted a conflict of interest policy under federal, state or local law that may satisfy these requirements. For example, many nonprofits have already adopted a version of the IRS model conflict of interest policy, which is generally consistent with the Act's requirements. Additionally, each director must submit a statement regarding potential conflicts of interest prior to his or her election to the Board and annually thereafter.

Attorney General May Approve Certain Corporate Transactions Without Court Involvement

The Act simplifies the process for applying for approval of nonprofit merger or consolidation plans, changes in corporate purposes and asset dispositions. Historically, nonprofits were required first to obtain approval of the Attorney General, and then to obtain approval of the State Supreme Court. Once the Act is in effect, nonprofits may apply for an order of approval directly from the Attorney General, which should simplify and expedite the approval process. If the Attorney General disapproves the application or concludes that court review is appropriate, then the organization may seek judicial review of the transaction.

Financial Reporting Threshold Changes

The Act clarifies and increases the revenue thresholds for nonprofits that must make annual financial reports to the Attorney General.

- **Less than $250,000 in annual gross revenue:** A nonprofit must file unaudited financial statements, regardless of how little annual gross revenue is earned.
- **Between $250,000 and $500,000 in annual gross revenue:** A nonprofit must file audited financial reports and an independent CPA's review report.
- **Greater than $500,000 in annual gross revenue:** A nonprofit must file annual financial statements along with an independent CPA's audit report and opinion letter.

Beginning on July 1, 2017, the annual gross revenue threshold for filing audited financial reports along with an independent CPA audit report and opinion letter will increase to $750,000. The threshold will increase again to $1,000,000 beginning on July 1, 2021.

Audit Oversight Requirement Imposed

The "independent directors" of a nonprofit with annual revenues over $500,000 that is required to register with New York State to conduct charitable solicitations must oversee the organization's accounting and financial reporting and the audit of its financial statements. The Act defines an "independent director" as someone who is not (or whose relative is not) an employee of the nonprofit for the past three years and does not have another type of financial relationship with the nonprofit, as specifically defined in the Act. An Audit Committee that is solely composed of independent directors may also perform this function.

In addition to these duties, nonprofits with annual revenues greater than $1,000,000 that are required to register with New York State to conduct charitable solicitations are subject to additional audit oversight requirements. These nonprofits must review and discuss with the independent auditor the scope and planning of the audit prior to its commencement, any material risks and weaknesses in internal controls identified by the auditor, any restrictions on the scope of the auditor's activities, significant disagreements between the auditor and management, and the adequacy of the nonprofit's accounting and financial reporting processes. They must also consider the performance and independence of the auditor on an annual basis.

These provisions do not go into effect until January 1, 2015 for nonprofits with annual revenues less than $10 million in the last fiscal year ending prior to January 1, 2014.

Elimination of Corporate Types

Existing New York nonprofit corporations are categorized by type (A, B, C, and D) according to their specific purpose. Under the Act, these four types are eliminated and replaced with two classes of nonprofit corporations:

- "Charitable" corporations organized for charitable, educational, religious, scientific, literary, or cultural purposes, or for the prevention of cruelty to children or animals; and
- "Non-charitable" corporations organized for civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, or animal husbandry purposes, or for the purpose of operating a professional, commercial, industrial, trade, or service association.

Corporations formed prior to July 1, 2014 will be automatically deemed "charitable" or "non-charitable" corporations based on their earlier type.

Type	Post-July 1, 2014 Classification
Type A	Non-Charitable
Type B	Charitable
Type C	Charitable
Type D	Charitable, if formed for charitable purposes
	Non-charitable, if not formed for charitable purposes

Other Changes to Governance Requirements

The law also enables nonprofits to conduct board votes and other actions via e-mail, conduct board meetings via videoconference, and delegate the approval of small transactions to committees.

Preparing for Implementation

While many of the legislative changes made by the Act streamline, clarify or reaffirm existing obligations of nonprofits, organizations may want to use the Act's enactment as an opportunity to reassess corporate policies and processes in light of the Act's requirements and best practices. These actions may include reviewing existing conflict of interest and whistleblower policies, reviewing policies on assessment and approval of compensation arrangements and related party transactions, coordinating with fiscal staff regarding the status of required state filings, and updating corporate bylaws.

For specific guidance on governance and oversight changes that may be required to comply with the new law, please contact your usual Ropes & Gray advisor or the attorneys listed below:

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