



WORKSHOP X.

Moving Towards Civil Gideon

*2014 Legal Assistance
Partnership Conference*

Hosted by:

The New York State Bar Association
and The Committee on Legal Aid



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NEW YORK STATE BAR ASSOCIATION 2014 PARTNERSHIP CONFERENCE

X. A LANDSCAPE REDEFINED: GOVERNANCE AND MANAGEMENT CHANGES IN NEW YORK LAW

AGENDA

**September 11, 2014
11:45 a.m. – 1:15 p.m.**

1.5 Transitional CLE Credits in Professional Practice.

*Under New York's MCLE rule, this program has been approved for all attorneys,
including newly admitted.*

Panelists:

Courtney Darts, Esq., Senior Staff Attorney, Pro Bono Partnership
Linda Schechter Manley, Esq., Legal Director, Lawyers Alliance for New York

- | | |
|---|----------------------------|
| I. Structure New York Not-For-Profit Corporations | 11:45 am – 11:50 am |
| II. Nonprofit Revitalization Act Governance Issues | 11:50 am – 12:25 pm |
| a. Charitable Corporations | |
| b. Non-Charitable Corporations | |
| c. Operational Issues | |
| d. Bylaws | |
| III. Board of Directors | 12:25 pm – 12:40 pm |
| a. Qualification and Selection of Directors | |
| b. Actions of the Board | |
| c. Board Committees and Required Policies | |
| d. Officers | |
| IV. Members | 12:40 pm – 12:55 pm |
| a. Qualifications for Membership | |
| b. Membership Meetings | |
| c. Staff | |
| V. Executive Compensation and Insider Transactions | 12:55 pm – 1:05 pm |
| a. Intermediate Sanctions under the IRC | |
| b. Rebuttable Presumption of Reasonableness | |
| c. Bonuses and Discretionary Payments | |
| d. Revenue Sharing Transactions | |
| e. Penalties, Correction and Abatement | |
| f. Related Party Transactions under State Law | |
| g. Executive Compensation under State Law | |
| h. Third Party Liability | |
| VI. Question & Answer | 1:05 pm – 1:15 pm |

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Substantive Outline

X. A LANDSCAPE REDEFINED: GOVERNANCE AND MANAGEMENT CHANGES IN NEW YORK LAW

OUTLINE

*Reprinted with authorization from Advising Nonprofits, Lawyers Alliance for New York 5th Edition,
Sean Delany & Elizabeth Perez Editors Chapters 2 & 3*

I. STRUCTURE NEW YORK NOT-FOR-PROFIT CORPORATIONS

Not-for-profit corporations in New York are governed by the N-PCL. Not-for-profit corporations are formed for purposes permitted by the N-PCL and not for pecuniary profit.¹ There are two “types” of New York not-for-profit corporations:²

A. Charitable Corporations

1. Any not-for-profit organization formed for a charitable purpose should be formed as a charitable corporation, including organizations with both charitable and non-charitable purposes.³ Charitable purposes include those that are “charitable, educational, religious, scientific, literary, cultural or for the prevention of cruelty to children or animals.”⁴ Organization formed prior to the enactment of the Nonprofit Revitalization Act will be designated as charitable corporations if they incorporated as a Type B or Type C corporation, and some Type D corporations may be also be designated as charitable corporations if the corporation’s purposes are charitable.⁵ Charitable corporations may elect to establish a membership organization, as described below.

B. Non-Charitable Corporations

1. Non-charitable organizations are “formed for any one or more of the following non-pecuniary purposes; civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, or animal husbandry, or for the purpose of operating a professional, commercial, industrial, trade or service association.”⁶

C. Operational Issues

1. No part of the income or assets of a charitable corporation may be distributed to members, officers or directors, except as permitted by law. (For example, reasonable compensation may be paid for services rendered to the corporation.) Not-for-profit corporations do not issue shares, and they are therefore not “owned” by anyone.⁷ They are controlled, as discussed below, by their directors and officers, and by members if the organization is a membership corporation. Not-for-profit corporations may act only in

¹ See N-PCL § 201.

² N-PCL § 201(b).

⁵ N-PCL § 201(b).

⁶ N-PCL § 102(a)(3-B).

⁷ N-PCL § 201(b).

⁶ N-PCL § 102(9-a).

⁷ N-PCL § 501.

furtherance of their not-for-profit purposes (as specified in the certificate of incorporation), in accordance with the N-PCL and their bylaws.

2. Members and directors have distinct legal rights and responsibilities under the N-PCL. As described in greater detail later in this chapter, directors and officers have fiduciary duties and manage the affairs and assets of the not-for-profit corporation. Members have the right to elect or remove members of the Board⁸ and vote on fundamental corporate decisions, such as amending the certificate of incorporation,⁹ approving a plan of merger,¹⁰ or dissolving the corporation,¹¹ and can amend the organization's bylaws.¹²

3. A not-for-profit corporation is formed by filing a certificate of incorporation of the corporation with the Secretary of State in Albany after all consents and approvals to such filing have been obtained.¹³ The contents of the certificate of incorporation are statutory and are specified in the N-PCL.¹⁴

D. Bylaws

1. An organization's bylaws contain the rules and procedures by which corporate decisions are made. Properly adopted bylaws are binding on an organization, and may be the subject of a legal proceeding by those with authority to do so to prevent action contrary to their provisions.¹⁵

2. Content of Bylaws

a. The bylaws may contain "any provision relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its members, directors or officers" which is not inconsistent with its certificate of incorporation, the N-PCL or other state law.¹⁶

b. Bylaws are distinguished from the certificate of incorporation. The certificate of incorporation is the organization's primary organizational document. The N-PCL specifies the basic information that must be set forth in the certificate of incorporation¹⁷ and governs the process for amending the certificate.¹⁸ By contrast, under the N-PCL, the adoption of bylaws is optional but will be binding

⁸N-PCL §§ 604, 706.

⁹N-PCL § 802.

¹⁰N-PCL § 903(a) (Consol. 2011).

¹¹N-PCL § 1102(a).

¹²N-PCL § 602. *See also* discussion of qualifications for membership and related requirements *infra* p. [22-24].

¹³*See* N-PCL §§ 404(a)-404(v).

¹⁴N-PCL § 402(a).

¹⁵*See Gray v. Canisius Coll.*, 76 A.D.2d 30 (N.Y. App. Div. 1980).

¹⁶N-PCL § 602(f) (Consol. 2011).

¹⁷N-PCL §§ 402(a), 402(c).

¹⁸N-PCL § 801-5; *see also* discussion of amending the certificate of incorporation *infra* Chapter 4.

on the corporation once adopted.¹⁹ Furthermore, the adoption or amendment of bylaws is a regular corporate action, meaning that it is approved by the corporation's Board of Directors or membership (if required) and is not subject to any further regulatory oversight. For this reason, corporations may prefer to include most of their internal rules and procedures in the bylaws and include only the most fundamental information required by the N-PCL in the certificate of incorporation.

c. One of the most important purposes of bylaws is to protect corporate decision-makers by providing clear guidance as to how corporate decisions should be made. If directors follow the bylaws and make decisions in good faith, they will generally be protected from liability.²⁰

d. Another means of regulating corporate activity includes the adoption of board resolutions authorizing specific corporate actions, such as opening a bank account or entering into a material contract. As is the case for any corporate decision, Board resolutions are adopted in accordance with the corporation's certificate of incorporation, bylaws and applicable law.

3. **“Statutory” Bylaw Provisions**

a. The N-PCL contains many provisions that govern the process of corporate decision-making. Many of the procedures and rules contained in these statutory default provisions may be changed in the bylaws. Unless this is done, however, the statutory provisions govern. Thus, every not-for-profit corporation in New York has a set of “statutory” bylaws with which it must comply in the absence of specific rules of its own.

b. Examples of “statutory” bylaw provisions include that, unless otherwise specified in the corporation's organizational documents:

- i. a Board must consist of at least three directors;²¹
- ii. a director's term of office is for one year;²²
- iii. and a quorum of directors consists of a majority of the entire Board.²³

4. **Adoption and Amendment of Bylaws**

a. Bylaws may be adopted by the members, by the Board of Directors, or by the incorporators at the initial organizational meeting. Unless otherwise provided in the certificate of incorporation or the bylaws, any bylaw adopted by the members may be amended or repealed by the Board.²⁴ A bylaw restricting the right of the

¹⁹See generally N-PCL § 602.

²⁰See generally DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS (Moyer Bell Ltd. 1988); *infra* Chapter 3.

²¹N-PCL § 702(a) (Consol. 2011).

²²N-PCL § 703(b).

²³N-PCL § 707.

²⁴N-PCL § 602(a).

Board to amend the bylaws may only be adopted by the members.²⁵

II. BOARD OF DIRECTORS

A. Overview

1. The Board of Directors is the governing body responsible for the overall conduct of the organization's activities and for making corporate decisions. In a non-membership corporation, directors are vested with all power to make corporate decisions. As described in greater detail later in this chapter, directors have a duty of care, a duty of loyalty and a duty of obedience to the corporation. N-PCL § 717(a) states that directors and officers shall "discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." However, N-PCL § 720-a provides that uncompensated directors and officers of 501(c)(3) organizations will be liable to third parties only in cases of gross negligence or intentional misconduct.²⁶
2. In addition, N-PCL §§ 715 through 719 contain provisions which impose liability on directors for self-dealing, making loans to themselves or other directors and the improper distribution of corporate assets. Directors may also be liable under normal fiduciary rules for mismanagement of assets entrusted to their care (such as endowment funds). Directors of private foundations must comply with strict regulations under the federal tax code.

B. Qualification and Selection of Directors

1. The bylaws or certificate of incorporation may prescribe qualifications for directors. Except in the case of certain youth programs, directors must be at least 18 years old.²⁷ United States citizenship is not a requirement.
2. The bylaws will normally also fix the number of directors of the corporation, with a statutory minimum number of three.²⁸ The bylaws may fix a definite number of directors, or may identify a maximum number who may be seated. In a corporation with members, a number of directors greater than three may also be fixed by action of the members or of the Board under the specific provisions of a bylaw adopted by the members. If no number is fixed, the Board will be required to have three directors.²⁹
3. The bylaws or certificate of incorporation must state the manner of election or appointment of directors; they may provide for directors to be elected or appointed by the membership at large, or by special sections of the membership, or by virtue of their

²⁵N-PCL § 602(c).

²⁶While the statute offers immunity to uncompensated directors and officers from third party claims where the plaintiff cannot prove gross negligence or intentional harm, § 720-a cannot offer immunity for directors and officers from federal claims, including federal employment litigation (*e.g.*, civil rights and wrongful termination suits) and federal tax claims. *See* VICTORIA B. BJORKLUND ET AL., NEW YORK NONPROFIT LAW AND PRACTICE §11.05[2][c] (Lexis Publications 2d ed. 2007); *see also* discussion of this statute *infra* Chapter 3.

²⁷N-PCL § 701(a) (Consol. 2011).

²⁸N-PCL § 702(a).

²⁹*Id.*

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current or former office in the corporation or in other public or private entities.³⁰ If the organization has members, the bylaws or certificate of incorporation may specify the proportion of the vote at a membership meeting necessary to elect the Board of Directors; a plurality is required if no other proportion is specified.³¹ If there are no members, the bylaws may also provide for a “self-perpetuating board,” in which the current directors elect the directors to fill vacancies on the Board.

4. The bylaws or certificate of incorporation may specify the term of office of directors, which may not exceed five years, except in the case of those elected or appointed by virtue of their office or former office in the corporation or other entity.³² In the absence of a provision fixing the term of office, it is one year.³³ The certificate of incorporation or a bylaw (adopted by the members if the corporation is a membership corporation) may also provide for classification of directors so that terms will be staggered.³⁴ If the directors are classified, the term may not exceed a number of years equal to the number of classes.³⁵

5. The N-PCL does not limit the number of terms a director may serve, but the bylaws may do so.

6. Except as limited by N-PCL § 706(c) (covering cumulative and class voting), directors may be removed for cause by the members, or by the directors provided there is a quorum of not less than a majority of the directors. The bylaws or certificate of incorporation may provide that any or all of the directors may be removed without cause by a vote of the members.³⁶ The N-PCL does not specifically authorize directors to remove other board members without cause.

7. The bylaws or certificate of incorporation may specify that vacancies on the Board of Directors may be filled by the members. Otherwise such vacancies may be filled by vote of a majority of the directors.³⁷

8. As of January 1, 2015, no employee of the corporation may serve as board chair or hold any other title with similar responsibilities.³⁸

C. Actions of the Board

1. The bylaws may establish the time and place of annual or regular meetings; if the bylaws are silent, the Board must establish the time and place. Meetings of the Board may be held anywhere inside or outside the state, unless the certificate of incorporation or

³⁰N-PCL § 703(a).

³¹N-PCL §§ 613(a), 615(a).

³²N-PCL §§ 703(b) (Consol. 2011).

³³*Id.*

³⁴N-PCL § 704.

³⁵N-PCL § 703(b).

³⁶N-PCL §§ 706(a), 706(b).

³⁷N-PCL § 705(a) (Consol. 2011).

³⁸N-PCL § 713.

bylaws fix a particular place.³⁹

2. The bylaws may prescribe what constitutes notice of a meeting of the Board.⁴⁰ Notice need not be given if the time and place of regular meetings of the Board of Directors are fixed by the bylaws. However, the bylaws may specify that notice of such meetings of the Board must be given. Notice must always be given for special meetings, although either attendance at the meeting or the written waiver of such notice can satisfy notice requirements.⁴¹

3. The bylaws may provide that notice of any adjournment of a meeting of the Board to another time and place must be given to directors not present at the time of the adjournment, and (unless such time and place was announced at the meeting) to other directors.⁴²

4. The president or another officer of the corporation specified in the bylaws or determined by the Board is entitled to call a special board meeting. If the corporation has no members, any director may call a special meeting upon written demand of not less than one-fifth of the entire Board.⁴³

5. Absent a provision in the certificate of incorporation or bylaws fixing a different minimum, a majority of the entire Board constitutes a quorum. If the certificate of incorporation or bylaws set the number of directors as a range, the entire Board is defined as the number of Directors elected at the last annual meeting plus those Directors serving out the remainder of their term.⁴⁴ The bylaws or certificate of incorporation may fix a lesser quorum, but if the Board has 15 or fewer members, the quorum must be at least one-third of the entire Board. If the Board has more than 15 members, the quorum must be at least five members plus one additional member for every ten members in excess of 15.⁴⁵ The certificate of incorporation or a bylaw adopted by the members may also establish a greater quorum.⁴⁶

6. The vote of a majority of the directors (assuming a quorum is present) constitutes an act of the Board.⁴⁷ The amendment of a certificate of incorporation or a bylaws adopted by the members may require a greater proportion.⁴⁸ Where there are no members, the Board, by a two-thirds vote of the entire Board, may also amend the certificate of

³⁹N-PCL § 710.

⁵⁰ N-PCL § 711. Either written or electronic notification is permissible.

⁴¹N-PCL § 711.

⁴²N-PCL § 711(d).

⁴³N-PCL § 710(c).

⁴⁴ N-PCL § 102(a)(6-a).

⁴⁵N-PCL § 707.

⁴⁶N-PCL § 709(a)(1).

⁴⁷N-PCL § 708(d).

⁴⁸N-PCL §§ 709(a)(2), 709(b).

incorporation or bylaws to require a greater proportion.⁴⁹

7. Unless prohibited by the certificate of incorporation or bylaws, the Board may take action even if one or more members are participating by conference telephone or video conference.⁵⁰ Proxy voting by directors is not authorized by the N-PCL.

8. Unless prohibited by the bylaws or certificate of incorporation, the Board may take action without a meeting if it obtains the written consent of all members.⁵¹

D. Board Committees and Required Policies

1. The bylaws or certificate of incorporation may authorize the Board to designate an executive committee and other committees of the board, each consisting of three or more directors. Committees of the board may have as much authority as the Board delegates to them, including the power to bind the corporation, subject to certain limitations.⁵² The bylaws may also provide for committees of the corporation or may authorize the Board to create them. Committees of the corporation may be comprised of individuals who are not board members, and do not have the authority to bind the board.⁵³

2. Although no organization is required under the N-PCL to establish either committees of the corporation or committees of the board, the N-PCL does require that organizations subject to reporting requirements pursuant to Exec. Law § 172(a)⁵⁴ ensure proper audit oversight either by the board or an audit committee of the board comprised solely of independent directors.⁵⁵

3. If the corporation has members, the Board must present at the annual members' meeting a financial report verified by the president and treasurer or by a majority of the directors, or certified by a public accountant.⁵⁶ If the corporation has no members, the president and treasurer must present such a report at the annual meeting of the Board.⁵⁷

4. The Board is also required to adopt a conflict of interest policy,⁵⁸ and, if the organization has 20 or more employees and annual revenue in excess of one million

⁴⁹N-PCL § 709(c).

⁵⁰N-PCL § 708(c).

⁵¹N-PCL § 708(b).

⁶² N-PCL § 712(a). This section of the N-PCL grants broad authority to the executive committee or any other committee of the board but denies them authority as to the following: (1) submission to members of any action requiring members' approval; (2) filling vacancies on the Board or any committee; (3) fixing compensation of directors for serving on the Board or any committee; (4) amending or repealing bylaws or adopting new bylaws; or (5) amending or repealing any board resolution which by its terms is not so amendable or repealable.

⁶³ N—PCL § 712(e).

⁶⁴ Executive Law § 172(a) requires most nonprofit organizations operating in New York State to file annual reports, including financial information, with the Charities Bureau of the Attorney General. For a discussion of these reporting requirements, see *infra* Chapter 6.

⁶⁵ For more information on audit oversight requirements, see *infra* Chapter 5.

⁵⁶N-PCL § 519(a).

⁵⁷N-PCL § 519(c).

⁵⁸ For a full discussion of the conflict of interest policy requirements, see *infra* Chapter 3.

dollars, a whistleblower policy.⁵⁹ The whistleblower policy must protect directors, officers, employees, and volunteers who report suspected improper conduct from retaliation, and the policy must include (1) provisions for reporting violations of law or corporate policies, (2) a designated individual to oversee the whistleblower policy and report on such policy to the board or audit committee, as applicable, and (3) a requirement that the whistleblower policy be distributed to all directors, officers, employees and volunteers.

E. Officers

1. The officers are the individuals who are responsible for certain functions of the corporation and who have the power to bind the corporation. The bylaws may provide for a president, vice-president, secretary and treasurer, and for any additional officers. The certificate of incorporation or the bylaws may designate alternate titles for these officers. The bylaws may spell out the authority and responsibilities of the officers; otherwise the Board of directors does so.⁶⁰ Not-for-profit corporations have a high degree of flexibility over appointing officers and determining their responsibilities. Officers' positions may be filled by directors, members or staff, although paid staff may not serve as the chair of the Board of directors.⁶¹
2. The Board elects or appoints the officers unless the certificate of incorporation or a bylaw adopted by the members authorizes the members to elect all officers (or specified officers) or authorizes the president to appoint some or all of the other officers (subject to approval by the Board).⁶² Any two offices may be held by the same person, except the offices of president and secretary. The certificate or bylaws may provide that one or more officers shall be ex-officio members of the Board, with voting rights unless specified otherwise.⁶³
3. All officers must be elected or appointed annually unless otherwise provided in the certificate of incorporation or the bylaws.⁶⁴
4. An officer elected or appointed by the Board may be removed by the Board with or without cause. An officer elected by the members (or a class of members) may be removed, with or without cause, only by the members or the class of members with authority to do so, but the Board may suspend for cause an officer's authority to act.⁶⁵

III. MEMBERS

A. Qualifications for Membership

1. Members of not-for-profit corporations play a role analogous to shareholders of

⁵⁹ N-PCL §§ 715(b).

⁶⁰ N-PCL § 713 (Consol. 2011).

⁶¹ N-PCL § 714(f).

⁶² N-PCL § 713(b).

⁶³ N-PCL § 713(d).

⁶⁴ N-PCL § 713(c).

⁶⁵ N-PCL § 714(a).

business corporations. Members have the power to elect the directors and to vote on fundamental corporate decisions. Corporations with the ability to choose whether or not to have members should consider whether it is realistic and practical to be held accountable to a class of members and to observe notice of meeting and other formalities required by the N-PCL. While a membership structure may be well-suited to grassroots and community-based organizations, the arrangement can be cumbersome. Members, for example, are authorized to approve a corporation's decision to dissolve or to amend its certificate of incorporation, which adds an additional layer of bureaucracy to corporate activity.⁶⁶

2. Not-for-profit corporations formed as a non-charitable corporation must have members while not-for-profit corporations formed as charitable corporations may choose whether or not to have members. If there will be no members, then the certificate of incorporation or the bylaws must so state. Individuals, corporations, joint-stock associations, unincorporated associations and partnerships may all be members of a not-for-profit corporation.⁶⁷ Qualifications for membership should be set forth in the certificate of incorporation or bylaws. Membership may be affected and evidenced by membership cards or certificates or other methods specified in the certificate of incorporation or bylaws.⁶⁸ If a corporation wishes to levy fees, dues or assessments on its members, the certificate of incorporation or bylaws must so specify.⁶⁹

3. Unless otherwise provided in the certificate of incorporation or bylaws, membership is terminated by death, resignation, expulsion, expiration of membership term or dissolution of the corporation.⁷⁰

4. Members have the right to adopt, amend or repeal bylaws. Unless the certificate of incorporation or bylaws otherwise provide, the Board of Directors also has this right.⁷¹ The N-PCL provides further that the Board of Directors and membership may amend or repeal any bylaw adopted by the other, provided, however, that the Board's powers may be limited in the certificate of incorporation or the bylaws adopted by the members.⁷² Therefore, members appear to enjoy more expansive rights than the Board because members may adopt, amend, or repeal the bylaws and restrict the Board's right to do the same.⁷³

B. Membership Meetings

⁶⁶N-PCL §§ 1102, 802.

⁶⁷N-PCL § 601(a).

⁶⁸N-PCL § 601(c).

⁶⁹N-PCL § 507(a).

⁷⁰N-PCL § 601(e).

⁷¹N-PCL § 602(b); *see also* discussion of the Board of Directors *supra* pp. [14-20].

⁷²N-PCL § 602(c).

⁷³*See* BJORKLUND ET AL., *supra* note 39, §§ 3.05, 9.01; *see also, id.* § 9.02 (noting, in part, that “[i]n an organization with ongoing conflict between the Board and membership, theoretically one could have a continuous loop of the directors amending and the members overriding a bylaw”).

1. The members are required to hold an annual meeting for the election of directors and the transaction of other business on a date⁷⁴ and at a place⁷⁵ fixed by or under the bylaws. At least one class of members must have full voting rights; however, the certificate or bylaws may provide that some classes of members have no voting rights, or rights to vote only in specified matters.⁷⁶
2. Additional or “special” meetings of the members may be called at any time by the Board or by anyone authorized in the bylaws or certificate of incorporation, as well as by a written demand of ten percent of the members eligible to vote.⁷⁷ Requirements as to notice of meetings include that:
 - a. notice may be in writing or by email and that it state the place, date and time of the meeting unless it is the annual meeting, the timeframe during which notice must be provided and appropriate methods of service as well as how members may waive notice of meetings.⁷⁸
3. A quorum exists at a meeting of the members when members entitled to cast a majority of the total number of votes at such a meeting are present.⁷⁹ The bylaws or certificate of incorporation may provide for a lesser quorum; however, the minimum quorum is (1) members entitled to cast 100 votes, or (2) one-tenth of the total number of votes, whichever is less.⁸⁰ The certificate of incorporation or a bylaw adopted by the members may also provide for a greater quorum.⁸¹ In recognition of the difficulties nonprofits may have in obtaining a quorum, N-PCL § 608(e) allows a member, director or officer (on notice to the Attorney General), or the Attorney General, to petition the supreme court in the judicial district where the office of the corporation is or was located to dispense with normal quorum requirements for conducting a membership meeting in the case where it has proved to be impracticable or impossible for the corporation to obtain a quorum of its members.⁸²
4. The certificate of incorporation or the bylaws may specify the proportion of the vote at a meeting of the members necessary to transact any business or any specified item of business; if no proportion is specified, a majority vote is required.⁸³ A requirement of a

⁷⁴N-PCL § 603(b) (Consol. 2011).

⁷⁵N-PCL § 603(a).

⁷⁶N-PCL § 612. For example, election of the Board of Directors may be the responsibility of a particular class of members composed of existing board members (who serve until their successors are elected).

⁷⁷N-PCL § 603(c).

⁷⁸N-PCL §§ 605(a), 606.

⁷⁹N-PCL § 608(a) (Consol. 2011).

⁸⁰N-PCL § 608(b).

⁸¹*Id.* In such a case the quorum requirements must be noted on the face of any membership card or certificate issued. N-PCL § 615.

⁸²N-PCL § 608(e). The petition must set forth the reasonable efforts that the corporation made to obtain a quorum, including the manner in which the corporation provided notice to its members of prior meetings.

⁸³N-PCL § 613(b).

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larger proportion of votes must be set forth either in the certificate of incorporation or in a bylaw adopted by the members, and must be noted on any membership card or certificate issued.⁸⁴ Each member has one vote, but the certificate of incorporation or bylaws may provide that if a corporation has an organization as a member, then such organization shall be entitled to a number of votes that is substantially proportionate to its membership.⁸⁵

5. Proxies for member voting are authorized under rules set forth in N-PCL § 609. The bylaws or certificate of incorporation may specify that proxy voting is not permitted and may change the rules governing the use of proxies. Proxies may be authorized in writing or by email.⁸⁶

6. If the bylaws or certificate of incorporation so provide, the bylaws may specify (or the Board may fix) a record date to determine the members entitled to vote or to take any other action or to receive particular benefits. If a record date is authorized by the certificate of incorporation or the bylaws but none is fixed, the record date for the determination of members entitled to vote at a meeting is the date preceding the day on which notice of the meeting is given or, if no notice is given, the day of the meeting.⁸⁷

7. There may be more than one class of membership within an organization. The designation and characteristics of each class, and the rights, qualifications and limitations upon the members of each class may be set forth in the certificate of incorporation, the bylaws or, if the bylaws so provide, a resolution of the Board.⁸⁸ The voting powers of each membership class may be limited and defined by the bylaws or certificate of incorporation. In fact, the bylaws or certificate of incorporation may provide that members of a class are not entitled to vote at all. However, at least one class of members must have full voting rights.⁸⁹

8. The quorum for a membership class consists of members entitled to cast a majority of the total number of votes entitled to be cast by the class.⁹⁰ A quorum as low as members entitled to cast ten percent of the votes, or 100 votes, whichever is lesser, may be established by the certificate of incorporation or bylaws.⁹¹ A higher quorum may be established by the certificate of incorporation or a bylaw adopted by the members, but this fact must be noted on any membership card or certificate issued.⁹²

9. The certificate of incorporation or the bylaws may specify the proportion of the vote

⁸⁴N-PCL § 615.

⁸⁵N-PCL § 611(e).

⁸⁶N-PCL § 609.

⁸⁷N-PCL § 611(c).

⁸⁸N-PCL §§ 601(b), 616.

⁸⁹N-PCL §§ 612, 616.

⁹⁰N-PCL § 608(a).

⁹¹N-PCL § 608(b).

⁹²N-PCL § 615.

of the class required to transact business. If they do not, a plurality is required for the election of directors and a majority for other corporate action.⁹³ A requirement for a greater proportion of the vote must be set forth either in the certificate of incorporation or in a bylaw adopted by the members, and must be noted on any membership card or certificate issued.⁹⁴

10. The bylaws or certificate of incorporation may provide for cumulative voting, which allows members to cast votes equal to the total number of membership votes they hold, multiplied by the number of directors to be elected to the Board. With cumulative voting, members may allocate all of their votes to one candidate or among multiple candidates.⁹⁵

C. Staff

1. Staff members who are paid employees and volunteers are responsible for implementing the corporation's programs. The executive director of a not-for-profit is part of the organization's staff. If staff members also serve as directors, it is important for the Board to adopt procedures to manage the conflicts of interest that will arise due to those dual roles.⁹⁶ In addition, the N-PCL explicitly restricts an employee of the organization from serving as the chair of the Board of directors.⁹⁷

2. The Board of directors is charged with adequate oversight of the staff's activities. Directors should therefore evaluate the executive director's performance on a regular basis, and exert appropriate fiscal controls through review and approval of the corporation's budget and fund raising practices.⁹⁸

IV. EXECUTIVE COMPENSATION AND INSIDER TRANSACTIONS

Both federal and New York State law regulate insider party transactions and executive compensation. IRC § 4958 covers all “excess benefit transactions” in which “disqualified persons” engage. While the N-PCL addresses related party transactions and executive compensation, Executive Order 38 further regulates executive compensation paid by certain New York State contractors.

A. Intermediate Sanctions under the IRC

1. The purpose of IRC 4958 is to impose excise taxes on managers and other influential persons in tax-exempt organizations who receive excessive economic benefits from the organization, rather than punishing the organization itself by revoking its tax-exempt status. These “intermediate sanctions” enable the IRS to enforce tax regulations without imposing penalties that would further damage organizations that have already

⁹³N-PCL § 616(b).

⁹⁴N-PCL § 615.

⁹⁵N-PCL § 617. This statute is analogous to BCL § 618, except that the N-PCL allows cumulative voting if adopted in the certificate of incorporation or bylaws and the BCL permits cumulative voting only if adopted in the certificate of incorporation.

⁹⁶A conflict of interest would exist, for example, if a staff member participated in directors' discussions or votes pertaining to his or her own salary or benefits. *See* discussion of conflicts of interest *infra* Chapter 3.

⁹⁷ N-PCL § 714(f).

⁹⁸*See* discussion of financial management and internal controls *infra* Chapter 5.

suffered unfavorable transactions.⁹⁹ It is important for such organizations to know which economic benefits are considered “excessive,” which persons are “disqualified” from receiving excess benefits, and the steps organizations can take to show that a benefit was reasonable.

2. In general, IRC 4958 intermediate sanctions apply to tax-exempt organizations described in IRC 501(c)(3) or IRC 501(c)(4).¹⁰⁰ Intermediate sanctions, however, do not apply to private foundations described in IRC 509(a), or to governmental units or affiliates of governmental units if they are tax-exempt without regard to IRC 501(a) or relieved from filing an annual return.¹⁰¹ IRC 4958 has a “look-back” period of five years, meaning that sanctions apply to an organization that engaged in an excess benefit transaction with anyone who was a disqualified person for a period going back five years from the date of the excess benefit transaction.¹⁰²

3. Excess Benefit Transactions

- a. For a transaction to be considered an excess benefit transaction:
 - i. the transaction must transpire between a disqualified person and an applicable tax-exempt organization; and
 - ii. the economic benefit conveyed to the disqualified person must exceed the value of whatever the disqualified person is providing to the organization.¹⁰³
 - a) An economic benefit is not treated as consideration for goods or services unless the organization clearly documents its intent to treat the benefit as compensation when the benefit is paid.¹⁰⁴
- b. In determining whether a transaction provided an excess benefit, one must consider all benefits and services exchanged between the disqualified person and the organization and its entities, although some economic benefits are disregarded for the purposes of IRC 4958.¹⁰⁵ Such benefits include the following:
 - i. non-taxable fringe benefits under IRC 132;
 - ii. expense reimbursement payments pursuant to “accountable plans”;¹⁰⁶

⁹⁹ 26 C.F.R. §§ 53.4958-1 to -8 (2012).

¹⁰⁰ 26 C.F.R. § 53.4958-2.

¹⁰¹ *Id.*

¹⁰² 26 C.F.R. § 53.4958-2(a)(1).

¹⁰³ 26 C.F.R. § 53.4958-4(a)(1).

¹⁰⁴ 26 C.F.R. § 53.4958-4(c)(1) (2012).

¹⁰⁵ 26 C.F.R. § 53.4958-4(a)(4).

¹⁰⁶ An “accountable plan” covers “reimbursement or other expense allowance arrangements” described under 26 C.F.R. §1.62-2. An employer’s reimbursement of expenses under an accountable plan is not reported as pay. To qualify as an accountable plan, the following conditions must be met: (a) expenses must have a “business connection,” which are “deductible employee business expenses” or “other bona fide expenses related to the employer’s business;” (b) employees must substantiate the expenses to the employer within a “reasonable period of time” and (c) employers must return any excess reimbursement or allowance within a “reasonable period of time.” While what constitutes a “reasonable period of time” will vary depending on the facts and circumstances, the substantiation of expenses within 60 days of receipt and the

- iii. benefits provided to a charitable beneficiary;
- iv. benefits provided to volunteers if the same benefit is available to the public for a membership fee; benefits provided to a member of, or donor to, the organization if the member paid a membership fee or if the donor's contribution was tax-deductible; and certain economic benefits provided to a governmental unit.¹⁰⁷

4. **Disqualified Persons**

- a. A person is a "disqualified person" in relation to an applicable tax-exempt organization if the person was in a position to exercise substantial influence over the affairs of the organization at any time during the five year lookback period ending on the date of the excess benefit transaction.¹⁰⁸ As set forth in more detail below, certain persons, such as family members of a disqualified person, are deemed to be automatically disqualified.¹⁰⁹ Some persons are disqualified based on their powers and responsibilities within the organization regardless of their job title.¹¹⁰ All relevant facts and circumstances are considered when determining whether a person is disqualified.¹¹¹
- b. Persons who hold certain powers and responsibilities in tax-exempt organizations are automatically deemed to be in a position to exercise substantial influence over an organization's affairs. IRC 4958 provides a list of such persons, including but not limited to:
 - i. Voting members of the governing body include persons who are entitled to vote on any matter over which the governing body has authority so long as the governing body is affiliated with the organization.¹¹²
 - ii. Presidents, chief executive officers and chief operating officers include any person who has the ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization, regardless of the individual's actual job title.¹¹³ Unless otherwise demonstrated, it is assumed that a person with one of the above listed titles has such ultimate

return of excess reimbursement or allowance within 120 days after payment will meet IRS safe harbor guidelines. 26 C.F.R. §1.62-2(g)(ii); *see also* I.R.S., PUBLICATION 463, TRAVEL, ENTERTAINMENT, GIFT & CAR EXPENSES 30 (2010), <http://www.irs.gov/pub/irs-pdf/p463.pdf>.

¹⁰⁷ 26 C.F.R. § 53.4958-4(a)(4).

¹⁰⁸ 26 C.F.R. § 53.4958-3(a)(1).

¹⁰⁹ 26 C.F.R. § 53.4958-3(b) (2012).

¹¹⁰ 26 C.F.R. § 53.4958-3(c).

¹¹¹ 26 C.F.R. § 53.4958-3(e).

¹¹² 26 C.F.R. § 53.4958-3(c)(1).

¹¹³ *See* 26 C.F.R. § 53.4958-3(c)(2); *Caracci v. I.R.S.*, 456 F.3d 444, 446 (5th Cir. 2006) (finding the founders/executive directors of a tax-exempt corporation to be disqualified under IRC 4958).

responsibility, even if the title is shared.¹¹⁴

iii. Treasurers and chief financial officers include any person with the ultimate responsibility for managing the finances of the organization, regardless of job title or of the title shared. If a person holds such a title it is assumed he or she has ultimate responsibility for managing finances.¹¹⁵

iv. If a hospital participates in a provider-sponsored organization, then any person with a material financial interest in the provider-sponsored organization has a substantial influence with respect to the hospital.¹¹⁶

5. Per Se Disqualified Persons

a. A person is always considered a disqualified person if he or she is a family member of another disqualified person with respect to an organization. IRC 4958 limits a person's family to the following:

- i. spouse;
- ii. siblings (full or half);
- iii. spouses of siblings (full or half);
- iv. ancestors;
- v. children;
- vi. grandchildren;
- vii. great grandchildren; and
- viii. spouses of children, grandchildren and great grandchildren.¹¹⁷

b. A corporation, partnership or trust is itself considered to be a disqualified person if it owns 35 percent or more of the combined voting power, profits interest, or beneficial interest.¹¹⁸

6. Persons Without Substantial Influence

a. Some persons are deemed not to be in a position to substantially influence an applicable tax-exempt organization, and therefore are not disqualified persons.

These persons include the following:

- i. 501(c)(3) tax-exempt organizations;
- ii. certain 501(c)(4) tax-exempt organizations; and
- iii. employees receiving economic benefits of only a limited amount in a taxable year.¹¹⁹

7. Facts and Circumstances Test

¹¹⁴ See 26 C.F.R. § 53.4958-3(c)(2) (2012).

¹¹⁵ 26 C.F.R. § 53.4958-3(c)(3).

¹¹⁶ 26 C.F.R. § 53.4958-3(c)(4).

¹¹⁷ 26 C.F.R. § 53.4958-3(b)(1).

¹¹⁸ 26 C.F.R. § 53.4958-3(b)(2).

¹¹⁹ 26 C.F.R. § 53.4958-3(d) (2012). For tax year 2012, the amount used in the definition of "highly compensated employee" under 26 U.S.C.S. 414(q)(1)(B)(i) is \$115,000. See I.R.S., *IRS Announces Pension Plan Limitations for 2012*, Oct. 20, 2011, <http://www.irs.gov/newsroom/article/0,,id=248482,00.html>. The tax code provides for annual cost-of-living adjustments of this dollar amount, pursuant to 26 U.S.C.S. § 415(d).

a. If a person is not deemed to be a disqualified person, or if he or she is not in a position whose powers and responsibilities make him or her disqualified, then all relevant facts and circumstances must be considered to determine whether he or she has a substantial influence over the organization.¹²⁰

8. Substantial Influence

a. IRC 4958 provides guidelines to show which facts and circumstances tend to show or not show substantial influence.

i. Indications of Substantial Influence

a) The following facts and circumstances tend to constitute substantial influence over an organization:

- 1) the person founded the organization;
- 2) he or she made substantial monetary contributions to the organization;¹²¹
- 3) the person's income primarily derives from a function of the organization under his or her control;
- 4) the person has or shares the authority to make financial decisions;
- 5) he or she manages a discrete, substantial segment or activity of the organization;
- 6) the person owns a controlling interest in a disqualified corporation, partnership or trust; or
- 7) the person is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.¹²²

ii. Lack of Substantial Influence

a) The following facts and circumstances tend to show that the person does not have substantial influence over an organization:

- 1) the person has taken a bona fide vow of poverty in affiliation with a religious organization;
- 2) the person is a contractor whose sole role is to provide advice and not benefit;
- 3) directly from financial transactions;
- 4) the person's direct supervisor is not disqualified;
- 5) the person does not participate in management decisions; or
- 6) any preferential treatment given to a person based on

¹²⁰ 26 C.F.R. § 53.4958-3(e)(1).

¹²¹ A "substantial contributor" is any person (including the grantor of a trust) who contributed or bequeathed an aggregate of more than \$5,000 to the organization, if that amount is more than 2% of the total contributions and bequests received by the organization before the end of the organization's tax year. 26 U.S.C.S. § 507(d)(2) (LexisNexis 2012).

¹²² 26 C.F.R. § 53.4958-3(e)(2).

monetary contribution is offered to all persons giving similar contributions.¹²³

9. Reasonable Compensation

- a. If compensation is found to be reasonable, then there is no excess benefit transaction. The main criterion in determining reasonableness is whether the amount of compensation would ordinarily be paid for similar services by similar enterprises under similar circumstances.¹²⁴
- b. The IRS considers all relevant facts and circumstances when determining reasonableness, including, but not limited to the following:
 - i. compensation paid by similarly situated organizations, both taxable and non-taxable;¹²⁵
 - ii. the availability of similar services in the geographic area of the organization;
 - iii. current compensation surveys compiled by independent firms; and
 - iv. actual written offers from other firms to the disqualified person.¹²⁶
- c. Reputable firms independent of both the disqualified person and the organization should compile the compensation surveys, and such surveys should cover the period during which the transaction occurred as well as include similarly situated organizations.¹²⁷

B. Rebuttable Presumption of Reasonableness

1. It is always in the best interests of the disqualified person and the organization to have the organization's Board of Directors (or any authorized affiliated body to which the Board has delegated power, such as a committee of the Board of Directors) approve any economic benefit transaction, because this potentially triggers the rebuttable presumption that the compensation was reasonable. Three criteria must be met, however, before the rebuttable presumption applies.
2. **Individuals Without Conflicts of Interest**
 - a. First, the authorized decision-making body affiliated with the organization must be composed entirely of individuals who do not have conflicts of interest

¹²³ 26 C.F.R. § 53.4958-3(e)(3).

¹²⁴ 26 C.F.R. § 53.4958-4(b) (2012).

¹²⁵ Compensation data can be gathered from Forms 990 filed by other organizations. See description of how Forms 990 are publically available *infra* Ch. [6].

¹²⁶ See Lawrence M. Brauer & Leonard J. Henzke, *Intermediate Sanctions (IRC 4958) Update*, 2003 EO CPE TEXT, at E-22, available at <http://www.irs.gov/pub/irs-tege/eotopice03.pdf> [hereinafter *Intermediate Sanctions (IRC 4958) Update*].

¹²⁷ *Id.* at E-23; see *Caracci v. I.R.S.*, 456 F.3d 444, 459-462 (5th Cir. 2006) (the court reversed a U.S. Tax Court decision primarily because the Tax Court relied on a compensation survey that did not use appropriately comparable organizations; the survey used dissimilar for-profit entities instead of similarly situated nonprofit entities. The 5th Circuit Court ruled that had the Tax Court used proper valuation techniques, it would have determined that the value of the compensation did not exceed the value of the services provided. The best compensation surveys should include all similar nonprofit organizations in the same geographic/metropolitan area that paid compensation to similar people for similar services. For-profit organizations should be avoided unless they are extremely similar to the applicable nonprofit organization.).

with respect to the transaction.¹²⁸ If the Board or other properly established authorizing body has a member with a conflict of interest with respect to the particular transaction, approval of the transaction is valid only if the interested member does the following:

- i. meets with other members only to answer questions;
- ii. recuses himself or herself from the meeting; and
- iii. is not present during debate and voting on the proposed transaction.¹²⁹

3. **Comparison With Similar Transactions**

a. Second, the authorized body must compare the proposed transaction to similar transactions made by similar organizations to similar persons, and in making this comparison, obtain and rely upon appropriate data.¹³⁰ Appropriate data would include, but not be limited to:

- i. compensation levels paid by similar organizations to comparable positions;
- ii. the availability of similar services in the organization's geographic area;
- iii. independently compiled compensation surveys; and
- iv. actual written offers from similar organizations competing for the services of the same disqualified person.¹³¹

4. **Adequate Documentation**

a. Third, the authorized body must document its process at the time of approving the transaction, up to and including the final approval.¹³² If the organization fails to provide this written contemporaneous substantiation, the services provided by the disqualified person will not be taken into account when determining the reasonableness of the transaction—in other words, without

¹²⁸ 26 C.F.R. § 53.4958-6(a)(1). The IRS recommends that organizations adopt and evaluate a written conflict of interest policy. The instructions to Form 1023 provide a sample. See I.R.S., *Instructions for Form 1023* app. A at 25-6 (2006), <http://www.irs.gov/pub/irs-pdf/i1023.pdf>. In summary, such policy should contain the following major categories: (1) purpose (the purpose of the conflicts of interest policy as protecting the tax-exempt organization's interest); (2) definitions (provide definitions of an interested person and financial interest); (3) procedures (the conflicts of interest policy should set forth the procedures for (a) disclosing and addressing a conflict of interest, and (b) taking action if the governing Board or committee determines that a member has failed to disclose a conflict); (4) records of proceedings (the minutes of the governing Board and committees must also contain detailed information about the conflict of interest and the persons who were present for discussions and the content and votes relating to the transaction); (5) compensation (the conflicts of interest policy should also contain provisions relating to voting and providing of information from voting members from members who receive compensation); (6) annual statements (each director, principal officer and member of a committee with governing board delegated powers should sign an annual statement relating to the policy); (7) periodic reviews (an organization should engage in a periodic review of its conflicts of interest policy); and (8) use of outside experts (the organization should decide whether or not it wishes to use outside advisors, however, use of such outside advisors shall not relieve a governing Board of its responsibility for the policy).

¹²⁹ 26 C.F.R. § 53.4958-6(c)(1)(ii) (2012).

¹³⁰ 26 C.F.R. § 53.4958-6(a)(2).

¹³¹ See *Intermediate Sanctions (IRC 4958) Update*, *supra* note [], at E-37.

¹³² 26 C.F.R. § 53.4958-6(a)(3).

substantiation, the IRS will view the transaction as having no consideration.¹³³
Proper documentation methods include:

- i. reporting the transaction on a tax return form;
- ii. executing an approved written employment contract; and
- iii. a writing that indicates the Board of Directors or other approved decision-making body approved the transaction before the date of its execution.¹³⁴

C. Bonuses and Discretionary Payments

1. Bonuses and other discretionary payments are subject to the same scrutiny as any other economic benefit. The IRS will compare a bonus payment with all other payments made to a disqualified person and then compare that to similar payments made by similar organizations to similar disqualified persons.¹³⁵
2. The IRS provides the following example of a bonus situation:

IRS EXAMPLE

A 501(c)(3) tax-exempt organization pays its president \$50,000 per year for five years. At the end of the fifth year, the organization pays the president a bonus of \$35,000 so the president and his/her spouse could take a cruise around the world. The organization intends to reward the president's previous five years of service. The IRS suggests that the \$35,000 benefit would be reasonable as compensation either for the previous five years of service (rated as \$7,000 per year) or for the final year of service in which he was paid the \$35,000.¹³⁶

Whether this bonus is treated as an excess benefit transaction depends entirely upon how the organization and the president report the \$35,000.¹³⁷ First, the organization must withhold income and employment taxes from the \$35,000. Next, the organization must contemporaneously document the decision to pay the bonus, as discussed above in § 4-D. Finally, both the organization and the president must report the \$35,000 on the appropriate tax forms (Form 990¹³⁸ and W-2 for the organization; Form 1040 for the president) in the year in which the organization makes the payment. If both parties satisfy these conditions then the IRS will likely find that no excess benefit transaction occurred.

However, if the organization does not withhold taxes on the bonus, and if the organization does not contemporaneously document the process that led to the bonus payment, and if neither the organization

¹³³ 26 C.F.R. § 53.4958-4(c)(1).

¹³⁴ 26 C.F.R. § 53.4958-4(c)(3) (2012).

¹³⁵ See Lawrence M. Brauer & Leonard J. Henzke, Jr., 'Automatic' Excess Benefit Transactions Under IRC 4958, 2004 EO CPE TEXT, at 14-19, available at <http://www.irs.gov/pub/irs-tege/eotopice04.pdf> [hereinafter 'Automatic' Excess Benefit Transactions].

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ See discussion of requirements for Form 990 *infra* Ch.6.

nor the president reports the bonus on the appropriate tax forms, then the IRS will likely find that the bonus constituted an excess benefit transaction.¹³⁹

This scenario illustrates the importance of documenting and reporting every payment in a timely fashion. Even if the IRS would have deemed a bonus reasonable when compared to similar payments by similarly situated nonprofit organizations to similar disqualified persons, the transaction may still be an improper excess benefit without proper documentation.

D. Revenue Sharing Transactions

1. IRC 4958's section addressing revenue sharing transactions has been reserved, meaning that the IRS is still considering whether special rules are needed when a potential excess benefit transaction comes directly from the revenues of the organization.¹⁴⁰ However, this does not mean that IRC 4958 does not cover shared revenue transactions. The best practice is to assume that the IRS will investigate shared revenue transactions in the same manner as other potential excess benefit transactions. The IRS will compare similar transactions between similar organizations and similar disqualified persons, and take into account all facts and circumstances to determine if the amount of the benefit exceeds the value the disqualified person provides the organization.¹⁴¹

E. Penalties, Correction and Abatement

1. Penalties

a. If a transaction between a disqualified person and applicable nonprofit organization is found to be an excess benefit transaction, the disqualified persons must pay an excise tax equal to 25 percent of the excess benefit.¹⁴² Multiple disqualified persons in one transaction are jointly and severally liable for the tax.¹⁴³ If a disqualified person liable for the 25 percent tax does not correct the excess benefit within the "taxable period", then that person is liable for an additional 200 percent of the excess benefit.¹⁴⁴ A manager of the organization is liable for an excise tax of 10 percent of the excess benefit if he or she oversees or participates in an excess benefit transaction.¹⁴⁵ Such an organization manager is

¹³⁹ *Id.*

¹⁴⁰ 26 C.F.R. § 53.4958-5 (2012).

¹⁴¹ 26 U.S.C.S. § 4958(a)(1) (LexisNexis 2012).

¹⁴² 26 U.S.C.S. § 4958(a)(1).

¹⁴³ 26 C.F.R. § 53.4958-1(c)(1).

¹⁴⁴ 26 C.F.R. § 53.4958-1(a). The taxable period begins on the date the excess benefit transaction occurs and ends on the earlier of (i) the date the IRS mails a statutory notice of deficiency to the taxpayer (as described under 26 U.S.C.S. § 6212) or (ii) the date the penalty tax is assessed. See IRS Form 4720 and Instructions, <http://www.irs.gov/pub/irs-pdf/f4720.pdf>. If a disqualified person makes a payment of less than the required amount, the 200 percent tax is assessed against the unpaid portion of the excess benefit. 26 C.F.R. § 53.4958-1(c)(ii). The 200% tax will be abated if the excess benefit is corrected within 90 days after the mailing of a notice of deficiency. Treas. Reg. § 53.4958-1(c)(2)(iii) (2012).

¹⁴⁵ 26 C.F.R. § 53.4958-1(a) (2012).

limited to \$20,000 maximum of tax liability per one excess benefit transaction.¹⁴⁶ This tax does not apply if the manager's participation was due to reasonable cause and was not willful,¹⁴⁷ with reasonable cause being equivalent to "ordinary business care and prudence."¹⁴⁸

2. Correction

- a. A disqualified person can correct an excess benefit transaction by undoing the excess benefit to the extent possible and taking additional measures to place the organization in a financial position not any worse than it would be under the highest fiduciary standards.¹⁴⁹
- b. In the case of a monetary excess benefit transaction, a disqualified person can correct the excess benefit if he or she repays the organization the amount of the benefit in cash or cash equivalents, plus interest, which accrues from the date the transaction occurred.¹⁵⁰
- c. In the case of an excess benefit property transfer, the disqualified person may correct the transaction by returning the specific property to the organization, but only if the organization agrees and the disqualified person and his or her family members do not participate in the decision.¹⁵¹ The disqualified person is treated as paying the lesser of either (1) the fair market value of the property when the transfer occurred, or (2) the fair market value of the property at the date of the return to the organization.¹⁵²
- d. In the case of an excess benefit transaction that results from vesting of benefits provided under a nonqualified deferred compensation plan, the disqualified person may correct the portion of the excess benefit from the undistributed deferred compensation by relinquishing any right to receive the excess portion of the undistributed compensation.¹⁵³
- e. Under a contract that has been partially performed, the parties may need to modify the terms of any ongoing contract to avoid future excess benefit transactions, however, termination of the contractual relationship between the organization and the disqualified person is not required for a correction of the excess benefit transaction.¹⁵⁴
- f. If the organization to be repaid is no longer tax-exempt or does not exist, then

¹⁴⁶ 26 U.S.C.A. § 4958(d)(2) (LexisNexis 2012).

¹⁴⁷ *Id.*

¹⁴⁸ *United States v. Boyle*, 469 U.S. 241, 246 (1985).

¹⁴⁹ 26 C.F.R. § 53.4958-7(a).

¹⁵⁰ 26 C.F.R. § 53.4958-7(b)-(c) (2012).

¹⁵¹ 26 C.F.R. § 53.4958-7(b)(4)(i), (iii).

¹⁵² 26 C.F.R. § 53.4958-7(b)(4)(i).

¹⁵³ 26 C.F.R. § 53.4958-7(b)(3).

¹⁵⁴ 26 C.F.R. § 53.4958-7(d).

the disqualified person must repay the excess benefit amount to a tax-exempt successor organization based on the dissolution clause in the certificate of incorporation.¹⁵⁵ The recipient organization must satisfy the following:

- i. be a public charity and must have been a public charity for 60 months prior to the repayment;
 - ii. the disqualified person must not be disqualified with respect to the recipient organization; and
 - iii. the recipient organization must not allow the disqualified person to make or recommend grants or distributions by the organization.¹⁵⁶
- g. If there is no qualified successor named in the dissolution clause, the repayment can be made to any tax-exempt organization that satisfies the above requirements.¹⁵⁷

3. **Abatement**

- a. If a disqualified person who has been assessed and has paid the 25 percent excise tax corrects the excess benefit transaction, the tax will be abated, meaning it is credited or refunded as an overpayment.¹⁵⁸ Abatement applies only if the excess benefit transaction occurred due to reasonable cause and not due to willful neglect.¹⁵⁹
 - i. Reasonable cause means exercising “ordinary business care and prudence,”¹⁶⁰ while willful neglect means that the disqualified person did not consciously, intentionally, or voluntarily fail to comply with IRC 4958, nor did he or she fail to comply due to conscious indifference.¹⁶¹
- b. If the disqualified person corrects his or her excess benefit transaction within 30 days after he or she discovers or acquires actual or constructive knowledge that it was an excess benefit transaction, and if he or she does so prior to being notified of examination by the IRS, then the IRS will automatically treat the disqualified person as having satisfied the requirements for reasonable cause and not willful neglect.¹⁶²

4. **Period of Limitations**

- a. The period of limitations on IRC 4958 excise taxes begins on the later of either:
 - i. the due date of the organization’s tax return, or

¹⁵⁵ 26 C.F.R. § 53.4958-7(e) (2012).

¹⁵⁶ 26 C.F.R. § 53.4958-7(e)(2).

¹⁵⁷ 26 C.F.R. § 53.4958-7(e)(3).

¹⁵⁸ See *Intermediate Sanctions (IRC 4958) Update*, *supra* note [], at E-47.

¹⁵⁹ *Id.*

¹⁶⁰ *United States v. Boyle*, 469 U.S. 241, 246 (1985).

¹⁶¹ See *Intermediate Sanctions (IRC 4958) Update*, *supra* note [], at E-48.

¹⁶² See 26 C.F.R. § 301.6724-1(d)(1)(ii)(D) (2012).

- ii. the date the organization filed its tax return.¹⁶³
- b. The period generally ends three years after it begins.¹⁶⁴ However, if the organization did not disclose the excess benefit transaction on its tax return so as to inform the IRS of its existence, then the period of limitations ends six years after it begins.¹⁶⁵

F. Related Party Transactions under State Law

1. The N-PCL is an additional source of authority on how directors should manage transactions with insiders to avoid breaching their duty of loyalty.
2. Under § 715 of the N-PCL, nonprofit corporations are prohibited from entering into a related party transaction unless the Board determines the transaction “to be fair, reasonable and in the corporation’s best interest.”¹⁶⁶ A related party transaction is a transaction or agreement between the nonprofit corporation or an affiliate and a related party who has a financial interest in the transaction.¹⁶⁷ If the transaction is one in which the related party has a “substantial financial interest” the board must:
 - a. consider alternative transactions, to the extent possible;
 - b. approve the transaction by a majority vote of the independent directors; and
 - c. contemporaneously document in writing the basis for the decision.¹⁶⁸
3. A Related Party Transaction is not necessarily a prohibited transaction. A nonprofit can participate in a related party transaction when the board determines that the transaction is fair, reasonable and in the best interests of the Corporation at the time of such determination.¹⁶⁹
4. The Attorney General has authority to bring an action to enjoin, void or rescind any related party transaction that is not approved by the Board in accordance with the N-PCL or that the Attorney General determines is not reasonable or in the best interests of the corporation.¹⁷⁰
5. While a corporation's certificate of incorporation or bylaws may contain additional restrictions on contracts or transactions with its directors or officers, the corporation may not set standards lower than those set forth in N-PCL § 715 as described above.¹⁷¹
6. **Related Party**
 - a. The concept of a related party under the N-PCL is similar to a disqualified person under the excess benefit transaction regulations. A “Related Party” is

¹⁶³ See *Intermediate Sanctions (IRC 4958) Update*, *supra* note [], at E-50.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ N-PCL § 715(a).

¹⁶⁷ N-PCL § 102(24).

¹⁶⁸ N-PCL § 715(b).

¹⁶⁹ N-PCL § 715.

¹⁷⁰ N-PCL § 715(f).

¹⁷¹ N-PCL § 715(c).

defined by the statute as:

- i. Directors, Officers, or Key Employees of the Corporation or an Affiliate of the Corporation;
- ii. Relatives of Directors, Officers, or Key Employees; or
- iii. any entity in which a person in (i) or (ii) has a 35% 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 5%.¹⁷²
 - a) A relative is a spouse, siblings (full or half); spouses of siblings (full or half); ancestors; children (whether natural or adopted); grandchildren; great grandchildren; spouses of children, grandchildren and great grandchildren; and domestic partners.¹⁷³
 - b) A “Key Employee” for purposes of New York State law is a person who is, or has within the last five years, been in a position to exercise substantial influence over the affairs of the Corporation. This includes, but is not limited to:
 - 1) Voting members of the Board;
 - 2) an Executive Director and/or Chief Financial Officer
 - 3) Employees who are “highly compensated” individuals who are in a position to influence the affairs of the corporation.¹⁷⁴
 - 4) Anyone who manages a discrete activity or segment of the Corporation that represents 10% or more of the assets, income, or expenses of the Corporation; or
 - 5) Anyone who has or shares authority to control 10% or more of the Corporation’s capital expenditures, operating budget or employee compensation.

7. Disclosure

- a. Any director, officer or key employee who as a financial interest in a transaction relating to the corporation or an affiliate has a duty to disclose the material facts related to their role to the board.¹⁷⁵ Before joining the board and annually thereafter directors must also complete a disclosure statement providing information about any entity in which the director is an officer, director, trustee, member, owner or employee and with which the corporation has a relationship.¹⁷⁶
- b. Review Transaction

¹⁷² N-PCL § 103(23).

¹⁷³ N-PCL § 102(22).

¹⁷⁴ I.R.C. § 414(q)(1)(B). The amount of compensation that triggers coverage as a “highly compensated” employee is adjusted annually and is currently \$115,000 per annum. IR-2013-86.

¹⁷⁵ N-PCL § 715(a).

¹⁷⁶ N-PCL § 715-(a)(c).

- i. Once the board is aware of a transaction in which a related party has a substantial financial interest it must determine whether the transaction is fair, reasonable and in the best interests of the corporation. This can be achieved by considering alternative transactions or comparability data.¹⁷⁷

8. Board Action

- a. Once the related party transaction is disclosed and the board has considered comparability data the board or a committee of the Board must meet and consider the transaction without the participation of the Related Party.¹⁷⁸ The Related Party is allowed to participate in deliberations or the vote with regard to the transaction although they may provide the board or committee with information prior to the vote.¹⁷⁹ The board must consider all the pertinent information and then decide if the transaction is fair, reasonable, and in the best interests of the corporation. If the board decides that a transaction is not in the organization's best interest then the board should reject it. Any transaction should be approved by a majority vote of the board members present, unless a higher percentage is required by the bylaws. The vote of each board member should be recorded with the minutes of the meeting and the comparability data should be included with the minutes.

9. Delegation to a Committee

- a. If the bylaws provide, the board can delegate the "adoption, implementation and compliance" with the conflict of interest policy to board committee comprised of Independent Directors.¹⁸⁰
 - i. An Independent Director is a member of the Board of Directors (the "Board") who:
 - a) has not been an employee of the Corporation or an Affiliate of the Corporation within the last three years;
 - b) does not have a Relative who has been a Key Employee of the Corporation or an Affiliate of the Corporation within the last three years;
 - c) has not received and does not have a Relative who has received more than \$10,000 in compensation directly from the Corporation or an Affiliate of the Corporation in any of the last three years (not including reasonable compensation or reimbursement for services as a Director, as set by the Corporation);
 - d) does not have a substantial Financial Interest in and has not been an employee of, and does not have a Relative who has a substantial Financial Interest in or was an Officer of, any entity

¹⁷⁷ N-PCL § 715(b)(1).

¹⁷⁸ N-PCL § 715(a).

¹⁷⁹ N-PCL § 715(g)

¹⁸⁰ N-PCL §712-a(c).

that has made payments to or received payments from the Corporation or an Affiliate of the Corporation in excess of the lesser of: (a) \$25,000 or (b) 2% of the Corporation's consolidated gross revenue over the last three years (payment does not include charitable contribution);

e) is not in an employment relationship under control or direction of any Related Party and does not receive payments subject to approval of a Related Party;

f) does not approve a transaction providing economic benefits to any Related Party who in turn has approved or will approve a transaction providing economic benefits to the Director.

b. Board members, prior to their election and annually thereafter must complete a disclosure statement.¹⁸¹

c. The New York State Attorney General has authority to bring an action seeking to enjoin, void or rescind a transaction that does not comply with the N-PCL or that the Attorney General deems not reasonable or in the best interests of the corporation.¹⁸²

d. Additionally, the Attorney General can seek restitution or removal of directors.¹⁸³ In the case of willful or intentional conduct, the Attorney General can seek a penalty of double the amount of "any benefit improperly obtained."¹⁸⁴

G. Executive Compensation under State Law

1. N-PCL § 202(a)(12) provides authority for corporations to pay compensation to "officers, employees and other agents of the corporation," in addition to directors, but that compensation must be "commensurate with services performed."¹⁸⁵ N-PCL § 715 also provides that the Board of Directors has the authority to fix the compensation of directors for services in any capacity unless otherwise provided in the certificate of incorporation or the bylaws.¹⁸⁶ If the fixing of salaries of officers is not in accordance with the bylaws of the organization, then such compensation decisions will require the affirmative vote of a majority of the entire Board of Directors unless a higher proportion is set by the certificate of incorporation or bylaws.¹⁸⁷

¹⁸¹ N-PCL §715-a(c).

¹⁸² N-PCL § 715-a(f).

¹⁸³ *Id.*

¹⁸⁴ N-PCL §715-a(f)(4).

¹⁸⁵ N-PCL § 202(a)(12).

¹⁸⁶ N-PCL § 715(d).

¹⁸⁷ N-PCL § 715(e); *see also Adelphi Univ. v. Bd. of Regents*, 229 A.D.2d 36 (N.Y. App. Div. 1997) (trustees failed to exercise the degree of care and skill that ordinarily prudent persons would have exercised in like circumstances to ensure that the compensation package for the University's President as a whole was reasonable and commensurate with services performed). Note that compensation decisions must be made in a manner consistent with IRS Intermediate Sanctions, as described above. Note further that the Better Business Bureau's Wise Giving Alliance's "Standards of Charitable Accountability" provides in part that "[N]ot more than one or 10% (whichever is greater) directly or indirectly compensated

OUTLINE:
A Landscape Redefined

2. Setting compensation for a board member, Officer or Key Employee is a Related Party Transaction and must be reviewed accordingly.¹⁸⁸
3. **Executive Order 38**¹⁸⁹
 - a. Executive Order 38 was signed by Governor Cuomo in 2012 in an effort to limit the state funding which is used to compensate executives and reimburse state contractors for administrative expenses.
 - b. Nonprofit organizations that contract with one of 13 State agencies¹⁹⁰ to provide services and whose state revenue is at least 30% of their overall revenue and more than \$500,000 annually are covered providers.
 - c. New York State is concerned about the portion of its funding that is being used to fund non-program costs and therefore, has applied a cap on support for administrative expenses. This cap is initially set at 25% and decreases by 5% each year until 2015, when the cap on administrative expenses will be set at 15%.
 - d. Executive Order 38 also places limits on executive compensation paid to those working at organizations that receive state funding, even under circumstances where that compensation is paid from non-state funding sources. As a general matter, a covered provider may not use more than \$199,000 in state funds annually to pay compensation to covered executives, unless it obtains a waiver from the State. However, covered providers may pay compensation in excess of \$199,000, if the organization without a waiver from the state if it satisfies both of the following criteria:
 - i. the compensation is equal to or less than 75% of compensation given to comparable executives in organizations “of the same size and within the

person(s) [may serve] as voting member(s) of the Board. Compensated members shall not serve as the Board's chair or treasurer." Furthermore, directors receiving compensation will forego the protection of the "gross negligence" standards in N-PCL § 720-a and the Volunteer Protection Act (described in greater detail below). *See* overview of the Better Business Bureau's Wise Giving Alliance *infra* Ch. [1].

¹⁸⁸ N-PCL § 715.

¹⁸⁹ Executive Order 38 has been the subject of lawsuits by contractors subject to the limitations it imposes. The following information assumes the validity of the regulations resulting Executive Order 38, but organizations should consult with the applicable contract managers and/or legal counsel to determine the status of Executive Order 38. *Agencies for Children's Therapy Servs., Inc. v New York State Dept. of Health*, 2013 NY Slip Op 30610(U) (Sup. Ct. Nassau County).

¹⁸⁹ 112 The 13 agencies that have issued EO 38 regulations are: (1) Department of Health

1. Office for People with Developmental Disabilities
2. Office of Mental Health
3. Office of Alcoholism and Substance Abuse Services
4. Office of Children and Family Services
5. Office of Temporary and Disability Assistance
6. Office for the Aging
7. Division of Criminal Justice Services
8. Office of Victim Services
9. Department of Corrections and Community Supervision
10. Department of Agriculture and Markets
11. Division of Housing and Community Renewal
12. Department of State

same program service sector and the same or comparable geographic area,” as established by a compensation survey recognized by the Division of the Budget,¹⁹¹ **and**

ii. the compensation was reviewed and approved by the provider’s board of directors or equivalent governing body, including at least two independent directors, and the review assessed appropriate comparability data. (If the review is conducted by a compensation committee, it must be reviewed and ratified by the full board.)

e. These limits on executive compensation do not apply to those staff members who provide program rather than administrative services.¹⁹² Additionally the limitations do not apply to contracts entered into earlier than July 1, 2012 and that end by April 1, 2015.

f. Organizations that seek a waiver must do so within 180 days of the end of their fiscal year. Among the factors that will be considered is comparable compensation provided to executives performing similar functions for other organizations.¹⁹³ Additionally, covered providers must complete the “EO#38 Disclosure Form,” within 180 days of the end of their fiscal year.

g. If the State finds that a covered provider has violated the Executive Compensation rules it must provide notice and a six-month period for provider to cure the violation. At the end of that six-month period if the violation is not cured the State may impose sanctions including redirection of state funds; suspension, modification, limitation, or revocation of the provider’s license to deliver the services; suspensions, modification, or termination of contracts; or other penalties.

h. N-PCL § 716 prohibits loans by a corporation to its directors or officers, or to any other corporation, firm, association or entity in which any director or officer is a director or officer or holds a substantial financial interest, with the exception of loans from one charitable corporation to another charitable corporation.¹⁹⁴

H. Third Party Liability¹⁹⁵

1. In general, corporate directors will not be held liable for corporate debts or

¹⁹¹ To date, the state has not approved any specific salary survey and has instead provided a list of factors that should be followed when using comparable salary information. <http://executiveorder38.ny.gov/sites/default/files/Guidance-002.pdf>

¹⁹² The limits do not limit state reimbursement for “reasonable compensation paid to a covered executive for program services,” which are defined as “those services rendered by a covered provider or its agent directly to and for the benefit of members of the public (and not for the benefit or on behalf of the State or the awarding agency) that are paid for in whole or in part by State funds or State-authorized funds.”

¹⁹³ *Preliminary Guidance: EO #38 and Related Regulations* at 38.

<http://executiveorder38.ny.gov/sites/default/files/Guidance-002.pdf>

¹⁹⁴ N-PCL § 716 specifies that the borrower's obligation to repay the loan is not affected by this provision, but any director who authorized a loan in contravention of the statute has violated his or her duty to the corporation.

¹⁹⁵ See for a discussion on indemnification and insurance *infra* Chapter 10.

obligations¹⁹⁶ or for the performance of contracts.¹⁹⁷ Limiting personal liability is a traditional reason to incorporate, and courts will not disregard the corporate entity except to remedy fraud, illegality or injustice.¹⁹⁸

2. Further, directors are generally not personally liable for torts¹⁹⁹ committed by the corporation or by one of its officers merely by virtue of the office they hold.

3. Notwithstanding these traditional protections provided by the corporate form, directors may be held liable to third parties for malfeasance or nonfeasance in their role as directors. To be liable, a director must participate, have knowledge amounting to acquiescence or be guilty of negligence in the management or supervision of the corporate affairs that caused or contributed to the injury.²⁰⁰ Boards of directors are usually far removed from the commission of tortious acts. The basic requirement of personal participation in the tortious act makes it difficult to establish the tort liability of directors and officers, and explains the scarcity of third party tort claims against directors.²⁰¹ Nevertheless, liability of directors is often alleged by third parties, such as discharged employees, on the theory that those directors failed to supervise the corporation's operations adequately.

4. **New York Standard of Care in Third Party Actions**

a. In 1986, the New York State legislature amended the N-PCL and added a new § 720-a, which limits the third party liability of certain not-for-profit directors and makes clear that directors covered by the law are to be judged by a "gross negligence" standard rather than the general negligence standard outlined in the discussion on the duty of care above. The 1986 law applies only to persons who serve without compensation on the Boards of organizations that are tax-exempt under § 501(c)(3) of the IRC.

b. § 720-a specifically states that such directors shall not be liable to third parties unless the conduct of the director toward the third party constitutes gross negligence or was intended to cause the harm which gave rise to the action.²⁰²

¹⁹⁶See *Samuel Goldberg & Son, Inc. v. Siegel*, 8 N.Y.S.2d 897, 898 (N.Y. App. Div. 1938); *Faulk v. Milton*, 25 A.D.2d 314, 316 (N.Y. App. Div. 1966).

¹⁹⁷See *Dupack v. Nationwide Leisure Corp.*, 70 A.D.2d 568, 569-570 (N.Y. App. Div. 1979); *Halford v. 1st Jersey Secs.*, 182 A.D.2d 1003, 1004 (N.Y. App. Div. 1992).

¹⁹⁸See *Zubik v. Zubik*, 384 F.2d 267, 272 (3d Cir. 1967); *Hansen v. Everlast World's Boxing Headquarters, Corp.*, 296 A.D.2d 103, 109 (N.Y. App. Div. 2002).

¹⁹⁹ A tort is a legal, noncriminal, noncontractual wrong or injury committed against an individual or his or her property.

²⁰⁰See *Wakeman v. Dalley*, 51 N.Y. 27 (1872); *Michaels v. Lispenard Holding Corp.*, 11 A.D.2d 12 (N.Y. App. Div. 1960); *Greenway Plaza Office Park, LLC v. Metro Constr. Serv.*, 4 A.D.3d 328, 329 (N.Y. App. Div. 2004).

²⁰¹See *Zubik*, 384 F.2d at 273, n. 14 ("Counsel have been unable to cite a case where the corporate entity was disregarded to make an individual liable for tort.").

²⁰² A court denied defendant directors' immunity where defamation was alleged and there was evidence of intent to cause harm to the plaintiffs. See *Rabushka v. Marks*, 229 A.D.2d 899, 901 (N.Y. App. Div. 1996). Individual directors were not liable for copyright infringement where they acted within their authority as directors and there was no evidence of gross negligence. See *Scanlon v. Kessler*, 11 F.Supp.2d 444, 449 (S.D.N.Y. 1998).

- c. The 1986 law does not apply to “derivative actions” brought on behalf of the corporation by those with standing or by the New York State Attorney General, nor does it apply to actions brought under federal law or the laws of another state.²⁰³
- d. The legislature also amended the New York Civil Practice Law and Rules (“CPLR”) to provide for dismissal of an action upon the showing that a defendant is covered by N-PCL § 720-a.²⁰⁴ The statute places a heavy burden of proof on the plaintiff and reflects the legislature’s intent to eliminate litigation “in its earliest stages” against nonprofit volunteers.²⁰⁵
- e. At the federal level, the Volunteer Protection Act of 1997²⁰⁶ provides limited immunity from civil liability for a nonprofit volunteer acting within the scope of her responsibilities.²⁰⁷ The statute protects uncompensated directors and officers from third party actions “only where there is no willful or criminal misconduct, gross negligence, reckless misconduct or a conscious flagrant indifference to the rights or safety of the individual harmed by the [director or officer].”²⁰⁸ The statute protects against third party actions (not actions brought on behalf of the not-for-profit organization itself), and the statute does not protect against actions involving “a crime of violence, hate crime, sexual offense, violation of federal and state civil rights laws or acts committed under the influence of alcohol or drugs.”²⁰⁹
- f. The statute, therefore, provides a qualified immunity to uncompensated directors and officers similar to the protections afforded under N-PCL § 720-a. Like the limited protections offered by the N-PCL, certain third party suits against uncompensated directors and officers remain outside of the scope of immunity as set forth in the statute. The statute preempts state laws only “to the extent that

²⁰³ But note that several other states, including Delaware, have enacted similar laws.

²⁰⁴ An IRS letter showing that the corporation is exempt under Section 501(c)(3) would be sufficient proof of the defendant’s right to dismissal of the action unless the court finds that there is a reasonable probability that the plaintiff’s allegations constitute gross negligence or intentional harm. See N.Y. C.P.L.R. § 3211(a) (Consol. 2011). The motion to dismiss must be made before the service of an answer. *Woodford v. Benedict Cmty. Health Ctr.*, 176 A.D.2d 1115 (N.Y. App. Div. 1991). Plaintiffs must produce “evidentiary proof showing a fair likelihood of success” that they will be able to prove gross negligence in order to survive a motion to dismiss.

²⁰⁵ *Rabushka v. Marks*, 229 A.D.2d 899 (N.Y. App Div. 1996); see also BJORKLUND, VICTORIA B., ET AL., NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS – SECOND EDITION § 11.05(2)(c) (Lexis Publications, 2007) (noting that there have been few lawsuits involving this issue and therefore, “few guidelines articulated by the courts”).

²⁰⁶ 42 U.S.C.S. §§ 14501-14505 (Consol. 2012).

²⁰⁷ See 42 U.S.C.S. § 14503. Uncompensated directors and officers are considered to be “volunteers” as that term is defined in 42 U.S.C.S. § 14505. Reimbursement of reasonable expenses does not disqualify uncompensated directors and officers from the protections of the statute, but if an uncompensated director or officer receives anything of value from the corporation in excess of \$500 in lieu of compensation, such director or officer would no longer be deemed a “volunteer.” See 42 U.S.C.S. § 14505(6).

²⁰⁸ BJORKLUND, *supra* note 109, §11.05[2][c] n. 105.

²⁰⁹ *Id.*

such laws are inconsistent with [the] Act,” although states are authorized to adopt “additional protections from liability relating to volunteers”.²¹⁰

5. Statutory Liability

a. Corporate directors are, of course, liable for illegal or fraudulent activities of the corporation if the directors directly participated in the wrongful acts.²¹¹

Beyond that liability, certain federal and state laws explicitly provide for individual director liability for obligations of the corporation. Non-compliance with tax laws is one common violation by not-for-profit corporations. Directors may be liable for failure to comply with withholding tax obligations²¹² or, if not otherwise exempt, to collect or pay state sales and use taxes.²¹³ Directors may also be liable for failure to pay for workman’s compensation coverage and other regulatory obligations.

6. Helpful Advice For Avoiding Liability

a. Persons who serve on the Boards of not-for-profit corporations do face a risk of liability as a result of the decisions they make. However, a few rules serve to reduce the risk substantially:

- i. Board members should be familiar with the corporation’s organizational documents, and the specific responsibility of each board member should be understood. Members of the Board should attend meetings regularly and insist that all decisions be fully discussed and that written minutes be kept. The Board should establish policies covering potential trouble areas, such as self-dealing and compensation matters. Objections to board decisions should be placed in the record by the dissenting board members.
- ii. All of the corporation’s major contracts and program decisions should be reviewed by the Board. The Board should receive regular program reports by its officers and executive staff, and the qualifications of all staff members, as well as their authority, should be reviewed regularly. Clear personnel policies should be adopted.
- iii. The Board should make sure that the corporation’s bookkeeping and accounting practices are proper. It should receive regular financial reports, and should verify that all filings required by law are made on time. Outside advisors (including an independent accountant and corporate counsel) should be consulted whenever the Board is uncertain of its obligations.
- iv. The Board should develop a written personnel manual or employee

²¹⁰ 42 U.S.C.S. § 14502(a).

²¹¹ N.Y. PENAL LAW § 20.25 (Consol. 2011); *see also* PENAL LAW § 20.20 (outlining general statutory standards for determining when a corporation can be prosecuted for a criminal offense).

²¹² Rev. Rul. 84-83, 1984-1 C.B. 264; Rev. Rul. 2007-48, 2007-2 C.B. 129.

²¹³ *See* N.Y. TAX LAW §§ 1131, 1133 (2011).

handbook setting forth practices and procedures for management, employees and volunteers. Personnel policies will help the corporation avoid inconsistent personnel practices and serve as a communication tool to employees.²¹⁴

v. The Board should adopt sound internal controls and policies covering whistle-blowers, conflicts of interest and document retention and destruction. The new Form 990 requires organizations to disclose information on its governance practices in these areas, among others.

²¹⁴ See in-depth discussion on personnel policies *infra* Chapter 8.

A Landscape Redefined: Governance and Management Changes in New York Law

A Landscape Redefined: Governance and Management Changes in New York
Law

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Workshop Overview

- Time of change for nonprofits in NYS
- Nonprofit Revitalization Act
- New York State Gateway
- EO 38

Scope of the Nonprofit Revitalization Act

- First major overhaul of New York nonprofit corporate statute in more than 40 years
- Most changes became effective on July 1, 2014
- This presentation focuses on the impact of the Act on organizations incorporated and operating in New York State, in two main areas:
 - Governance Procedures
 - Related Party Transactions / Conflicts of Interest

3

Governance Procedures

4

Corporate Types

- Corporate “types” A,B,C, and D have been eliminated in favor of two categories of nonprofit corporations: charitable and non-charitable.
- Existing corporations are automatically reclassified:
 - Type A corporations = non-charitable.
 - Type B and Type C corporations = charitable.
 - Type D corporations = charitable if they were formed for charitable purposes and non-charitable if they were not.
- Charitable corporations can choose to be membership or non-membership – former Type Cs, take note!

5

Committees

- Committees of the board can bind the corporation.
 - All members of the committees must be board members.
 - Must have at least three members.
- All other committees are committees of the corporation and lack the authority to bind the corporation.
- Distinctions of special and standing committees are eliminated.

6

Definition of “Entire Board”

- Entire board means the total number of directors entitled to vote if there were no vacancies.
- If the bylaws provide for a fixed number of directors, that number shall be the entire board.
- If the bylaws provide for a range of directors, the entire board shall be the number of directors that were elected as of the most recent elections.

7

Videoconference

- Unless otherwise restricted in the certificate of incorporation or bylaws, board members may participate in meetings via video screen or conference call.
- Remote participants count towards quorum requirement and can vote.

8

E-mail

- Meeting notices, waivers of notice, and authorizations to act by unanimous written consent may all be sent via fax or e-mail.
 - Applies to both members and directors.
- If notice of a member meeting is provided by publication, the corporation must also post notice of the meeting on its website.
- A member may use e-mail to authorize another person to act as his/her proxy.

9

Real Property Transactions

- Majority of directors or a majority of an authorized committee may authorize purchase, sale, mortgage, lease, exchange, or other disposition of real property.
- If the property would constitute all or substantially all of the corporation's assets, the transaction must be authorized by 2/3 of the entire board (or a majority if there are 21 or more directors).
 - *Previously, a 2/3 board vote was required for ALL real property transactions.*

10

Updated Audit Thresholds

- The annual gross revenue that triggers the obligation to obtain and file with the Attorney General (AG) an audit by an independent CPA is increased from:
 - \$250,000 to \$500,000 as of July 1, 2014;
 - to \$750,000 as of July 1, 2017; and
 - to \$1 million as of July 1, 2021.
- The annual gross revenue that triggers the obligation to obtain and file with the Attorney General a review report by an independent CPA is increased from \$100,000 to \$250,000 as of July 1, 2014. However, if upon review of that report the AG determines that the organization should obtain an audit report, the organization must do so within 120 days.

11

Updated Audit Thresholds

Effective Date	Unaudited Financial Report	Independent CPA Review	Independent CPA Audit
Through June 30, 2013	< \$100,000	\$100,000	\$250,000
July 1, 2014	< \$250,000	\$250,000	\$500,000
July 1, 2017	< \$250,000	\$250,000	\$750,000
July 1, 2021	< \$250,000	\$250,000	\$1 million

12

Audit Oversight

- Corporations required to file an independent CPA's audit report with the AG must have the board or a designated audit committee comprised solely of independent directors oversee the corporation's accounting and financial reporting processes and audit.
- Annually, the board or audit committee must retain or renew the relationship with the auditor and review the results and any related management letter with the auditor.

13

Audit Oversight cont'd.

- There are additional duties for any organization that had in the prior year or expects to have in the current year annual revenue over \$1 million
 - Before the audit, review the scope and planning of the audit with the auditor;
 - After the audit, review and discuss additional items with the auditor;
 - Annually consider the auditor's performance and independence; and
 - Report on the audit committee's activities to the board (if these duties are performed by an audit committee instead of the full board).
- For corporations that had annual revenue of less than \$10 million for the last fiscal year ending prior to January 1, 2014, these provisions do not take effect until January 1, 2015.

14

Independent Director

“Independent director” is an individual who, within each of the last three years:

- (i) Is not and has not been a employee of the corporation or an affiliate;
- (ii) Has not received more than \$10,000 in compensation from the corporation or an affiliate; and
- (iii) Is not a current employee of, or does not have a substantial financial interest in, an entity that has made payments to or received payments from the corporation or an affiliate which exceeds the lesser of \$25,000 or 2% of such entity’s consolidated gross revenues. Charitable donations do not count as “payments.”

15

Extends to Relatives

“Independent director” is an individual whose relative within the last three years is/has not:

- (i) Is not and has not been a employee of the corporation or an affiliate;
 - (ii) Has not received more than \$10,000 in compensation from the corporation or an affiliate; and
 - (iii) Is not a current employee of, or does not have a substantial financial interest in, an entity that has made payments to or received payments from the corporation or an affiliate which exceeds the lesser of \$25,000 or 2% of such entity’s consolidated gross revenues. Charitable donations do not count as “payments.”
- “Relative” of an individual includes his/her spouse, domestic partner, ancestors, siblings (whether whole or half blood), children (whether natural or adopted), grandchildren, great-grandchildren, and the spouses of siblings, children, grandchildren, and great-grandchildren.

16

Board Chair

- No employee of the corporation may serve as board chair.
- This provision does not take effect until January 1, 2016 (change from original effective date of January 1, 2015).

17

Related Party Transactions Conflicts of Interest

18

Related Party Transactions

- A Related Party is:
 - A Director, Officer, or Key Employee of Corporation or affiliate (“Key Employee” refers to IRS excess benefit transaction rules);
 - Any Relative of any of the above; or
 - Any Entity in which any of the individuals described above has at least 35% ownership interest.
- A Related Party Transaction (“RPT”) is a transaction or agreement in which:
 - A Related Party has a financial interest; and
 - The Corporation or an affiliate is a party.

19

Limitations on RPT

- Any Director, Officer, or Key Employee with an interest in a RPT must disclose the material facts.
- The Corporation may not enter into an RPT unless the board has determined that the transaction is:
 - fair;
 - reasonable; and
 - in the Corporation’s best interests.

20

Board Review of RPT

- If a related party has a substantial financial interest in a transaction involving a charitable corporation, the board or an authorized committee shall:
 - consider alternative transactions to the extent available before entering into the transaction,
 - approve the transaction by at least a majority vote of the directors or committee members present, and
 - contemporaneously document in writing the basis for approval.

21

Conduct of Meeting

- A related party may not participate in deliberations or voting regarding a related party transaction
 - Includes executive compensation decisions
- The board or a committee may request that a related party be present to provide information before the deliberations or voting begin.

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Conflict of Interest Policy

- Every corporation shall adopt a conflict of interest policy that includes procedures for disclosing, addressing, and documenting RPTs.
- Organizations with existing conflict policies must review them for compliance with NPCL.
- Organizations that have adopted a conflict of interest policy required by federal, state or local laws that is substantially consistent with the conflict of interest policy required by the NPCL are deemed in compliance.

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Contents of Policy

- A definition of conflict of interest.
- The procedure for disclosing a conflict to the audit committee or board.
- A requirement that a person with a conflict not be present at or participate in board or committee deliberations or vote on the matter giving rise to the conflict.
- A prohibition against any attempt by the person with a conflict to improperly influence the deliberation or voting on the matter.
- A requirement that the existence and resolution of the conflict be documented, including in the minutes of any meeting at which the conflict was discussed or voted on.

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Contents of Policy: Disclosure

- Policy also must require that **before** a director is initially elected, and **annually** thereafter, the director must complete, sign and submit to the board secretary a written statement identifying:
 - any entity of which the director is an officer, director, trustee, member, owner, or employee; and
 - any transaction in which the corporation is a participant and in which the director might have a conflicting interest.
- The secretary must provide all statements to the audit committee chair or board chair.

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Whistleblower Policy

- Nonprofits with 20 or more employees and over \$1 million in annual gross revenue also must have a whistleblower policy that provides that people who report suspected wrongdoing within the organization will not suffer retaliation
- Policy must:
 - Set forth procedures for the reporting of suspected violations of laws or corporate policies and for maintaining confidentiality of reported information;
 - Require that an employee, officer, or director be designated to administer the policy and report to the audit committee or board; and
 - Be distributed to all directors, officers, employees, and “volunteers who provide substantial services to the corporation”
- If a nonprofit has adopted a whistleblower policy pursuant to federal, state or local laws that is substantially consistent with these requirements, it will be deemed compliant.

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Overview NYS Gateway

- NYS Gateway launched May 15, 2013
- Portal through which grants are publicized and through which contractors “prequalify”
- After July 31, 2013 nonprofit organizations working with certain state agencies must be prequalified in order to:
 - Bid on a contract
 - Register a contract amendment
 - Renew a contract

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PREQUALIFICATION

- Designed to facilitate state contracting
- Nonprofit organizations upload documents and responses to questionnaire to demonstrate organizational competence in areas of:
 - Compliance
 - Capacity
 - Integrity

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AGENCIES USING GATEWAY

- Council on the Arts
- Department of Agriculture & Markets
- Department of Corrections and Community Supervision
- Department of Economic Development
- Department of Environmental Conservation
- Department of Health
- Department of Labor
- Department of State
- Department of Transportation
- Division of Criminal Justice Services
- Division of Housing & Community Renewal
- Division of Military & Naval Affairs
- Division of Parole
- Division of Veterans' Affairs
- Governor's Traffic Safety Committee
- Office for People with Developmental Disabilities
- Office of Alcoholism & Substance Abuse Services
- Office of Children & Family Services
- Office of Homeland Security & Emergency Services
- Office of Mental Health
- Office of Parks Recreation & Historic Preservation
- Office of Temporary & Disability Assistance
- Office of Victims Services
- Quality of Care and Advocacy for Persons with Disabilities
- State Education Department
- State Office for the Aging

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GOAL PREQUALIFICATION

- Goal is to streamline contracting process
- Put documents in one place that multiple state agencies can access
- Not have to repeat with each new response to a RFP
- Prequalification valid for three years
- Must update vault as appropriate
 - Consider doing this annually with filing of new Form 990

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CHALLENGES

- Ask for policies and procedures that are not otherwise legally required
- Description of policies is vague
- Policies should be narrowly crafted to be legally compliant and reflect actual operations

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HR DOCUMENTS TO BE UPLOADED

- Senior Leadership Resumes or CV
 - ED, CFO, COO, CPO and similar
 - actual resume
 - document showing background, credentials
 - more than a brief paragraph
 - demonstrate qualifications
- Organizational Chart
 - explain reporting structure
 - no particular format

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HUMAN RESOURCES MANAGEMENT

Capacity Questions 6, 13, 14, 16, 19, 20, 21 ask for HR management best practices:

- Board reviews executive performance and compensation
- Written HR policies
- EEO policy is posted
- Automated payroll system
- Annual staff performance evaluations
- Staff development and training

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EXECUTIVE COMPENSATION

- NPCL permits “reasonable” compensation
- IRS prohibits excessive compensation
 - Smaller organizations can use 3 comparator-safe harbor to avoid excess benefit transaction liability
- NYS EO 38
 - applies to social services agencies receiving >\$500,000 AND >30% revenue from 13 NYS agencies
 - caps state funds used for annual executive compensation at \$199,000
 - must obtain waiver for compensation over \$199,000 even using non-state funds
 - not applicable to employment agreements entered into before 7/1/2012 that expire by 4/1/15

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WRITTEN HR POLICIES

- NYS law requires written policies about
 - hours of work
 - paid vacation, sick and personal days, if any
- Recommended provisions:
 - employment at will statement
 - hiring procedures
 - benefits
 - harassment
 - discipline and discharge
 - receipt

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CREATING HR POLICIES

- Reflect actual practices
- Appropriate to size, resources and mission
- Complies with federal, state, and NYC law
 - *beware policies created in another state*
- Review regularly and revise policies
 - whenever law changes
 - organization changes significantly

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ANNUAL STAFF PERFORMANCE EVALUATIONS

- Document skills and behaviors relevant to the job and to the organization as a whole
- Reflect needs of different departments and/or job groups
- More robust than “free form” and less onerous than a tax return
- Combine narrative and numerical ratings
- Reflect individual achievement and contributions to organization
- Relate to prior evaluations
- Encourage open communication

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STAFF DEVELOPMENT AND TRAINING

- Document that staff maintains professional licenses
- Provide onsite/offsite training to meet any continuing education licensing requirements
- New/enhanced job-related skills training
- Training/activities to promote effective collaboration within and across teams
- Corrective coaching

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REQUIRED POLICIES

- Anti-Nepotism
- Staff Code of Conduct
- Diversity
- Supervision and Performance Evaluation
- EEO
 - Federal (over 15 employees) or state poster

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ANTI-NEPOTISM POLICY

- Prevents employees from benefitting unfairly from a personal relationship
- Define “suspect” relationships
- Complete bar or prohibit only direct reporting?
- Relationships entered into after hire
- If employee in relationship must leave under the policy, need gender neutral rule

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STAFF CODE OF CONDUCT

- Articulates acceptable level of workplace behavior and personal conduct
- Promotes ethical conduct toward co-workers, consumers, volunteers, and vendors
- Staff signs receipt of code

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DIVERSITY POLICY

- Refers to employees, not consumers
- Scope has not been defined
- Nondiscrimination statement probably sufficient

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SUPERVISION AND PERFORMANCE EVALUATION POLICY

- Refers to performance evaluation
- Leaders inform employees whether they are meeting expectations
- Policy (may be EE Handbook Provision) should address:
 - frequency of formal written evaluations
 - who performs
 - who reviews
 - opportunity for employee comments

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RECOMMENDED POLICIES

The following additional policies are recommended for organizations with budgets over \$1 million:

- CEO Compensation
- Succession/Transition Plan
- Personnel Recruitment/Screening/Hiring
- Personnel “Retention and Retention” Plan

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CEO COMPENSATION POLICY

- Compensation Committee with expertise
- Pay for performance against objective goals
 - Annual written review
- Determine elements of compensation:
 - base pay
 - bonus
 - deferred compensation
 - pension
- Total compensation comparable to similar NFP's
 - 990 information
 - salary surveys
 - consultants

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SUCCESSION/TRANSITION PLAN

- What if ED suddenly departed?
- Identify current employee(s) who could replace ED
 - assess readiness
 - create timeline
 - identify training resources, if needed
- Identify external candidates
 - former staff
 - recruiters
- Transition
 - identify interim leaders
 - temporarily realign job duties

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POLICY ON PERSONNEL RECRUITMENT/SCREENING/HIRING

- No mandated form
- Policy appropriate to the organization
- Points to consider:
 - how does our organization recruit?
 - what screening is appropriate
 - employment history
 - criminal background
 - drug test
 - motor vehicle record
 - references
- Wage Theft Prevention Act
- I-9

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PERSONNEL RETENTION AND RETENTION PLAN

Thoughtful consideration of talent retention tools appropriate to organization:

- compensation philosophy
- paid time off
- flexible scheduling/telecommuting
- non-economic benefits
- staff development/career paths
- internal grievance system

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RESOURCES FOR CREATING POLICIES

- Lawyers Alliance for New York
- www.ideaencore.com
- www.crenyc.org
- www.councilofnonprofits.org
- www.boardsource.org
- www.shrm.org

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NYS Gateway Policies

- Conflict of Interest & Whistleblower Policies are Gateway Policies
- Governed by NPRA

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FISCAL OVERSIGHT

- Several questions relate to fiscal oversight practices (#1,2,3,15,16,16A,16B)
- Obligation of staff and board to ensure that charitable dollars are properly expended
- Use of electronic accounting & 3rd party payroll systems
- Importance of checks and balances
 - develop fiscal and internal control policy
 - systems for handling receipt and disbursement of money
 - check signing authority

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BOARD GOVERNANCE

- Several questions relate to board governance (#9,10,11,12,13,16)
- Board is responsible for oversight and management of the organization
 - Review key budgets
 - Financial statements
 - Key regulatory filings
- Board operations need to align with bylaws
 - NPCL offers flexibility
 - Need to amend bylaws to reflect actual practices

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DOCUMENT RETENTION POLICY

- Document Retention Policy – establishes time periods for retaining different categories of documents and procedures for storing and destroying documents
- Must be customized to reflect organizations regulatory and contractual obligations
- Should be approved by Board

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CATEGORIES OF DOCUMENTS

- Categories of documents to consider:
 - Organizational/Corporate Records
 - Financial/Accounting Records
 - Tax Records
 - Employee Records
 - Insurance Records
 - Contracts
 - Donations/Funder Records
 - Management Plans and Procedures

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CONTINUITY OF OPERATIONS PLAN

- Continuity of Operations Plan – identifies the steps that will be taken and strategies that will be used to restore business operations following an incident as quickly as possible.
- Resources that will have to be identified include:
 - Employees
 - Office space, furniture and equipment
 - Technology (computers, peripherals, communication equipment, software and data)
 - Vital records (electronic and hard copy)
 - Production facilities, machinery and equipment
 - Inventory including raw materials, finished goods and goods in production.
 - Utilities (power, natural gas, water, sewer, telephone, internet, wireless)
 - Third party services

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DEVELOPMENT OF CONTINUITY OF BUSINESS OPERATIONS PLAN

- FEMA provides a template
<http://www.ready.gov/sites/default/files/documents/files/BusinessContinuityPlan.pdf>
- Steps include:
 1. Conduct Business Impact Analysis – Consider the impact of a business shut down on your operations and how the impact could be mitigated.
 2. Recovery Strategies – Identify and document resource requirements that will be necessary for recovery. Close gaps between recovery requirements and current capabilities.
 3. Plan Development – Develop and document plan. Gain management approval.
 4. Testing – Test the plan.

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EMERGENCY PREPAREDNESS POLICY

- Emergency Preparedness Policy – details how an organization will safeguard its employees, business assets and business operations in the event of an emergency.
- Contrast to Continuity of Operations Plan
- Thorough planning will help to keep your staff and clients safe and protect the infrastructure that is essential to maximize the chances for recovery.

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EMERGENCY PREPAREDNESS PLAN

- Steps to consider:
 1. Assign a team to create a plan.
 2. Identify possible disasters and their potential impacts; conduct a risk analysis that identifies internal and external risks to operations.
 3. Consider how to safeguard assets
 4. Create a system for communicating with staff and clients. Create a phone or text chain
 5. Prepare to shelter in place
 6. Identify a meeting place
- FEMA has a sample policy:
http://www.ready.gov/sites/default/files/documents/files/sample_plan.pdf
- Nonprofit Coordinating Committee has a sample policy:
http://npccny.org/info/disaster_plan.htm

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SECURITY POLICY

- Security Policy – sets forth the procedures for safeguarding data and personally identifying information of staff and clients.
- Could also be policy regarding physically safety in the workplace and program sites.

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M/WBE POLICY

- M/WBE Policy – establishes that the organization will encourage the submission of bids by minority and/or women owned business enterprises when hiring a vendor or a subcontractor.
- Applies to contracts:
 - in excess of \$25,000.00 labor, services, supplies, equipment, materials or any combination of the foregoing, to be performed for, or rendered or furnished to the contracting Agency; or
 - in excess of \$100,000.00 for the acquisition, construction, demolition, replacement, major repair or renovation of real property and improvements thereon; or
 - in excess of \$100,000.00 for the acquisition, construction, demolition, replacement, major repair or renovation of real property and improvements related to a State assisted housing project.

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Overview

EO 38 regulations cap **executive compensation** and **administrative expenses** for certain nonprofits receiving funding directly from, or authorized by, New York State.

- **An organization is covered if** it receives more than \$500,000 annually in state funds/state authorized payments and such funds are at least 30% of its annual revenue.
- **Executive comp limit:** Covered organizations may not use these funds to pay more than \$199,000 a year to covered executives
 - non-state funds may be used for pay exceeding this amount, within limits
- **Administrative expenses limit:** Covered organizations may not use more than 25% of their state funding for administrative expenses.
- Annual Disclosure Statement
- Compliance must begin on first day of Covered Reporting Period beginning after July 1, 2013.
- **BUT**, there is a waiver process and several exceptions!

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Am I A Covered Provider?

- Receives more than \$500,000 annually (*averaged over prior 2 covered reporting periods*)
- from one or more of 13 specific New York State Agencies,
- either directly or through an agreement with another governmental or other entity ("State funds") or authorized by a state agency ("State-authorized payments") to provide program services, and
- at least 30% of annual in-state revenue comes from State funds or State-authorized payments.

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Which Agencies?

- Department of Health
- Office for People with Developmental Disabilities
- Office of Mental Health
- Office of Alcoholism and Substance Abuse Services
- Office of Children and Family Services
- Office of Temporary and Disability Assistance
- Office for the Aging
- Division of Criminal Justice Services
- Office of Victim Services
- Department of Corrections and Community Supervision
- Department of Agriculture and Markets
- Division of Housing and Community Renewal
- Department of State

The funding programs of each agency to which the restrictions apply are listed in Appendix B to the state's Guidance (pp 73-143)
<http://executiveorder38.ny.gov/content/guidance>.

What Are State Funds & State-authorized Payments?

- State funds are funding from the state's annual appropriations, whether coming directly from the state or indirectly through another entity.
- State-authorized payments ("SAP") are funds that are not State funds but are disbursed upon a New York state agency's approval or by another governmental unit within New York upon such approval (e.g. federal and county portions of Medicaid program payments).

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What Is My Covered Reporting Period?

All calculations related to coverage and compliance must be made with reference to the Covered Reporting Period. A nonprofit can choose either:

- Fiscal Year; or
- Calendar Year
- *Annual Cost Reporting Period must be used by nonprofits required to submit cost reports (see Guidance, Appendix C at p. 144).*

Automatic Exemptions

- governmental units in New York State;
- child service providers receiving certain child care subsidies pursuant to Block Grants under the New York Social Services Law (unless covered based on receipt of other State funds/SAP);
- individuals or entities where at least 75% of their program services paid for by State funds/SAP are provided by individual professional(s), partner(s) or owner(s), rather than by employees or independent contractors.

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Automatic Exemptions cont.

- individuals or entities providing primarily or exclusively products, rather than services (e.g. pharmacies and medical equipment suppliers); and
- entities within the same corporate family as a covered provider (unless covered based on receipt of other State funds/SAP).

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Compensation

Commencing July 1, 2013, effective the first day of organization's reporting period, no more than \$199,000 in State funds/SAP annually may be used to pay compensation to any covered executive.

- Covered Executive: compensated director, officer or "key employee" not compensated for specific program services
- Amount may be adjusted annually by Director of the Division of the Budget.

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What does compensation include?

Executive Compensation includes basically all cash and noncash payments reportable on W-2 or 1099, e.g.:

- base salary
- bonuses
- housing
- below market loans
- pension & other benefits not provided to other employees

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What does compensation exclude?

- legally mandated benefits (Social Security, Workers Compensation, NYS Disability, Unemployment Insurance);
- other benefits consistent with those provided to other employees; and
- reasonable compensation provided to render program services, including supervisory services outside of managerial or policy-making duties.

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Administrative Expenses

Starting the first day of the provider's reporting period after July 1, 2013, each covered provider may devote **no more than 25%** of state funding/state authorized payments to administrative expenses.

- This will decrease by 5% each year until 2015, when the cap will be 15%.
- If any contract or grant applies more stringent requirements, those more stringent requirements apply.

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What Is Included In Administrative Expenses?

- Included examples (to the extent these cannot be attributed directly to provision of program services):
 - portion of salaries and benefits of staff performing administrative and coordination functions;
 - portion of legal expenses
 - portion of office expenses, including:

<ul style="list-style-type: none"> - professional dues, - licenses, - permits, - subscriptions, - conference expenses, - publicity and annual reports 	<ul style="list-style-type: none"> - office supplies, - postage, - insurance premiums, - interest charges and equipment that is expensed (rather than depreciated) in cost reports
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What Is Excluded From Administrative Expenses?

- Excluded examples:
 - capital expenses
 - property rental, mortgage or maintenance expenses;
 - taxes or governmental assessments
 - equipment rental, depreciation and interest expenses, including expenditures for vehicles and fixed, major movable and adaptive equipment that is expensed (rather than depreciated) in cost reports
 - expenses that is expensed rather than depreciated in cost reports of an amount > \$10,000 that would otherwise be administrative, except it is non-recurring (not more often than once per 5 years) or not anticipated (e.g. litigation-related expenses); and
 - portion of salaries and benefits of staff performing development and research

It doesn't look good – can I get a waiver?

- A provider can apply for waiver of either the compensation cap or administrative expense percentage requirements or both.
- Waiver may be granted by the agency upon a showing of “good cause”.
- If granted, waivers are effective for covered reporting period (administrative expenses) or TBD by agency (executive comp).
- Waiver applications are addressed in the guidance at pages 7 to 9 (<http://executiveorder38.ny.gov/sites/default/files/Guidance-002.pdf>) and a waiver application form may be found here (<http://executiveorder38.ny.gov/content/EO-38-waiver-application-described-in-the-Guidance>.)

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Waiver Factors

- Executive Compensation:
 - extent to which compensation is comparable to that of comparable executives in other providers of the same size and program service sector and the same or comparable geographic area;
 - extent to which the compensation is necessary to provide the program services at the current level of quality and availability;
 - nature, size and complexity of the provider's operations and the program services provided;

Waiver Factors

- Executive Compensation (cont.):
 - provider's review and approval process for the compensation, including whether it involved board review and approval (and contemporaneous substantiation of the deliberation and decision to approve) and review by at least two independent board members and an assessment of comparability data including a compensation survey;
 - qualifications and experience possessed by or required for the executive or position, respectively; and
 - efforts to secure executives with the same levels of experience, expertise, and skills at lower levels of compensation.
 - "any other [factor] deemed relevant"

Waiver Factors

- Administrative Expenses:
 - extent to which the expenses are necessary or avoidable;
 - evidence that failure to reimburse specific expenses would negatively effect the availability or quality of program services in the provider's geographic area;
 - nature, size and complexity of the provider's operations and the program services provided;
 - provider's efforts to monitor and control administrative expenses and limit requests for reimbursement of such costs; and
 - efforts to find other sources of funding its administrative expenses.
 - "any other [factor] deemed relevant"

Waiver Timing

- Waiver applications are due not later than when the covered provider submits its EO#38 Disclosure Form (discussed below)
 - The agency will generally respond within 60 days
 - It is advisable to submit a waiver application as early as possible, to avoid making payments that may be in violation of the regulations.
- Waiver application should be submitted even if an organization is not yet sure whether it will be a covered provider, if it reasonably expects it may be a covered provider. <http://executiveorder38.ny.gov.faq-page#n2>
- A waiver application is available online: <http://executiveorder38.ny.gov/content/EO-38-waiver-application>
- Information is not subject to Freedom of Information Law

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Biographies

Courtney Darts is a Senior Staff Attorney in the Pro Bono Partnership's White Plains, New York office, where she advises nonprofit organizations on corporate and tax-exempt legal matters. She was previously in private practice with the law firm Kelley Drye & Warren LLP and is admitted to the bar in Connecticut and New York. She is a graduate of Fairfield University and Fordham University School of Law.

Linda Schechter Manley, Legal Director at the Lawyers Alliance, oversees client representation services and manages the in-house attorney staff. Ms. Manley has significant experience in the areas of childcare, elder services, mergers and strategic alliances, corporate restructuring, nonprofit governance and coping with financial distress. She also initiated Lawyers Alliance's initiative Program Preservation that helps nonprofits cope with the legal impact of the economic downturn at a time of increased demand for their services. From 1997-2006, Ms. Manley was a staff attorney and senior staff attorney at Lawyers Alliance. Previously, she was an associate at the law firms of Jones Day and Weil, Gotshal & Manges LLP, and she served as law clerk to Hon. Loretta A. Preska in the Southern District of New York. She received her J.D. from Fordham University School of Law in 1991 and B.A. magna cum laude from State University of New York at Albany in 1988. Professional Activities: Board of Trustees, Grand Concourse Academy Charter School.