INTRODUCTION

The New York Non-Profit Revitalization Act of 2013 (the “Act”) will take effect generally next month, on July 1, 2014. The Act addresses a number of antiquated provisions and procedures of the current Not-for-Profit Corporation Law (the “NPCL”) with the goal of lessening the burdens of the non-profit sector as well as improving the requirements for governance and oversight. This update summarizes key amendments made to the NPCL under the Act and certain of their implications for New York not-for-profit corporations.

The amendments to be highlighted in this update are the following:

1. Improved Governance and Oversight
   A. Tighter Restrictions on Related Party Transactions
   B. New Requirements for Conflicts of Interest Policies
   C. New Requirements for Whistleblower Policies

2. Enhanced Audit and Reporting Requirements
   A. Audit Committee Oversight Requirements
   B. New Definition and Requirement of Independent Directors
   C. New Revenue Thresholds for Financial Reporting Requirements
   D. Right to Petition the Supreme Court to Evaluate Alleged Wrongdoing

3. Streamlined Administrative Processes
   A. Elimination of Types of Not-for-Profit Corporations
   B. Allowance of Electronic Communications
   C. Simplification of Approvals of Substantial Transactions
   D. Reduction of Barriers of Entry for New Not-for-Profit Organizations
   E. Simplification of Committee Types
   F. Reduction in Board Approval Requirements for Real Property Transactions

4. Certain Other Amendments
   A. Personal Jurisdiction
   B. Agent for Service of Process
   C. Prohibition Against Employees Serving as Chairman of the Board
   D. Court Ordered Indemnification

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1 In this update, the terms “non-profit” and “not-for-profit” are used interchangeably.
1. IMPROVED GOVERNANCE AND OVERSIGHT

   A. **Tighter Restrictions on Related Party Transactions**

   Under the Act, the board or authorized committee of a not-for-profit corporation or charitable trust must determine that any related party transaction is fair, reasonable and in the best interest of the not-for-profit corporation by taking all three of the following actions before entering into such related party transaction:

   1. **Consider alternatives**: the board or authorized committee must consider alternative transactions to the extent possible;
   2. **Approve transaction by majority vote**: the board or authorized committee must approve the related party transaction by not less than a majority vote of the directors or committee members present at the meeting; and
   3. **Document the basis for approval**: the board or authorized committee must contemporaneously document in writing the basis for its approval of the related party transaction, including its consideration of any alternative transactions.

   Under the Act, the interested party in a related party transaction must do both of the following before entering into such transaction:

   1. **Disclose material facts**: the interested party must disclose the material facts concerning such interest in good faith to the board or authorized committee; and
   2. **Refrain from deliberations or vote**: the interested party must refrain from participating in deliberations or voting with respect to the related party transaction.

   The Act empowers the New York State Attorney General to commence proceedings to enjoin, void or rescind a related party transaction if such transaction violates the NPCL (as amended by the Act) or is otherwise deemed unfair, unreasonable or not in the best interest of the not-for-profit corporation at the time the transaction was approved. The Attorney General may also seek restitution or the removal of directors or officers of the not-for-profit corporation, or seek to require any person or entity to account for any profits made from such transaction and pay them to the not-for-profit corporation.

   **Recommended Actions – Related Party Transactions**:  

   **Board or authorized committee**: Prior to any related party transaction, identify the parties involved and their relationship to the transaction. If the transaction is a related party transaction, the board or authorized committee must follow the three steps listed above as well as make an affirmative determination, by a majority of the vote of the directors or committee members present at the meeting, that the transaction is fair, reasonable and in the best interest of the not-for-profit corporation.  

   **Interested parties**: Prior to participating in any related party transaction, disclose in good faith the material facts concerning your relationship in the transaction to the board or authorized committee, and refrain from participating in any discussions or votes relating to such transaction.

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2 A “related party transaction” is a transaction, agreement or other arrangement in which a related party has a financial interest and in which the non-profit corporation or an affiliate thereof is a participant.

A “related party” is (i) any director, officer or key employee of the non-profit corporation or any affiliate of the non-profit corporation; (ii) any of their respective relatives; or (iii) any entity in which any of the foregoing individuals 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%.

3 The Act applies in substantially the same manner to not-for-profit corporations and charitable trusts (and with respect to charitable trusts the Act refers to trustees rather than the board or committee). As this update is intended for not-for-profit corporations as its primary audience, for ease of review we have removed references to charitable trusts and trustees.
B. **New Requirements for Conflict of Interest Policies**

Every not-for-profit corporation must adopt a conflict of interest policy to ensure that its directors, officers and key employees act in the best interest of the not-for-profit corporation. The conflict of interest policy also assures compliance with legal requirements, including the requirements set forth above regarding related party transactions.

At a minimum, the conflict of interest policy must include the following elements:

1. **Definition of conflict of interest**: a definition of the circumstances that constitute a conflict of interest;
2. **Disclosure procedures**: procedures for disclosing a conflict of interest to the audit committee or the board;
3. **Recusal of person with conflict of interest**: a requirement that a person with a conflict of interest not be present at or participate in board or committee deliberations or voting on the matter giving rise to the conflict;
4. **Elimination of influence from the conflicted person**: a prohibition against any attempt by a conflicted person to influence deliberations or votes on the matter giving rise to the conflict;
5. **Documentation of conflicts**: a requirement that the existence and resolution of the conflict be documented in the not-for-profit corporation’s records;
6. **Documentation of related party transactions**: procedures for disclosing, addressing and documenting related party transactions; and
7. **Regular disclosure statements**: a requirement that directors submit a statement disclosing any potential conflicts of interest prior to joining the board and continue such disclosure statements on an annual basis thereafter.

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**Recommended Action – Conflict of Interest Policies**:

A tax exempt New York not-for-profit corporation should have already adopted a conflict of interest policy in response to the IRS Form 990, which not only asks whether the not-for-profit has a written conflict of interest policy but also asks for information about the process the not-for-profit uses to manage conflicts. However, now the not-for-profit corporation needs to be sure that its conflict of interest policy meets the required elements described above (unless it prefers to rely on the safe harbor and can clearly establish that it applies). If it does not have a conflict of interest policy yet, it should adopt a policy with all the required elements as soon as possible.

C. **New Requirements for Whistleblower Policies**

Any not-for-profit corporation with 20 or more employees and prior fiscal year revenue of more than $1 million must adopt a whistleblower policy. The whistleblower policy must prohibit intimidation, harassment, discrimination or other retaliation against any director, officer, employee or volunteer, or, in the case of an employee, adverse employment consequences, if such person in good faith reports an action or suspected action taken by or within the not-for-profit corporation that is illegal, fraudulent or in violation of any adopted policy.

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4 The Act provides a safe harbor for a not-for-profit corporation that has adopted a conflict of interest policy pursuant to federal, state or local law that is substantially consistent with the requirements within the Act. Since the term “substantially consistent” is not defined in the Act, it may be risky to rely on this safe harbor.

5 The Act provides a safe harbor for a not-for-profit corporation that has adopted a whistleblower policy pursuant to federal, state or local law that is substantially consistent with the requirements within the Act. Since the term “substantially consistent” is not defined in the Act, it may be risky to rely on this safe harbor.
Smaller not-for-profit corporations – those with fewer than 20 employees or prior year revenue of no more than $1 million – are not mandated to have a whistleblower policy. However, it may be advisable for even these smaller corporations to consider adoption of a whistleblower policy.

Whistleblower policies must meet the following requirements:

1. **Reporting procedures**: include procedures for reporting suspected violations of law or corporate policies, and for preserving the confidentiality of the reported information;

2. **Designation of an administrator**: designate a director, officer or employee of the not-for-profit corporation to administer the policy and to report to the audit committee or another committee of independent directors, or, if there is no such committee, the board; and

3. **Distribution of the policy**: the policy must be distributed to all directors, officers and employees, and to volunteers who provide substantial services.

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**Recommended Actions – Whistleblower Policies**

A tax exempt New York not-for-profit corporation should have already adopted a whistleblower policy in response to the IRS Form 990 which asks whether the not-for-profit has a policy to address whistleblowers. However, now the not-for-profit corporation needs to be sure that its whistleblower policy meets the requirements stated above.

**Not-for-profit corporations with 20 or more employees and revenue in the prior fiscal year of more than $1 million**: not-for-profit corporations of this size should check whether they already have a whistleblower policy. If so, they should check whether the policy meets all the requirements and address any shortcomings (unless they prefer to rely on the safe harbor and can clearly establish that it applies). If they do not have a whistleblower policy yet, they should adopt a policy that meets all the requirements as soon as possible.

**Not-for-profit corporations with fewer than 20 employees or revenue in the prior fiscal year of $1 million or less**: these not-for-profit corporations are not required to adopt a whistleblower policy, but if they have one, they should check that the policy meets all requirements and consider addressing any shortcomings. If they don’t have one, they should consider whether adopting a whistleblower policy is advisable as a matter of good organizational practice, particularly if they are a tax exempt not-for-profit corporation required to file the Form 990.

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**ENHANCED AUDIT AND REPORTING REQUIREMENTS**

The Act introduces audit oversight requirements for New York not-for-profit corporations that solicit contributions in New York and are currently required to file an independent certified public accountant’s (CPA) audit report with the Attorney General. The new oversight requirements focus on creating a more trustworthy environment for the non-profit sector.

**A. Audit Committee Oversight Requirements**

The law establishes three basic responsibilities for audit committees of smaller not-for-profit organizations and four additional responsibilities for audit committees of larger not-for-profit organizations. The threshold that defines smaller versus larger organizations for this purpose is $1 million in revenue, either in the prior fiscal year or in the organization’s reasonable expectation for the current fiscal year.

1. **Organizations with revenue of $1 million or less in the prior fiscal year or in the organization’s reasonable expectation for the current fiscal year**:

   (a) **Oversee the reporting**: oversee the accounting and financial reporting processes of the not-for-profit corporation and the audit of its financial statements;

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6 There is a grace period for audit oversight requirements until January 1, 2015, for any not-for-profit corporation with annual revenue of less than $10 million in its last fiscal year ending prior to January 1, 2014.
(b) **Review the independent auditor:** annually retain or review the retention of an independent auditor to conduct the audit; and

(c) **Review the results:** upon completion of the audit, review the results of the audit and any related management letter with the independent auditor.

(2) **Organizations with revenue of more than $1 million in the prior fiscal year or in the organization’s reasonable expectation for the current fiscal year:** the audit committee must fulfill the three responsibilities listed above, and also must:

(a) **Review the scope:** prior to the audit being performed, review the scope and planning of the audit with the independent auditor;

(b) **Review the audit:** following the completion of the audit, review and discuss with the independent auditor:
   
   (i) material risks and weaknesses in internal controls identified by the auditor;
   
   (ii) restrictions on the scope of the auditor’s activities or access to requested information;
   
   (iii) significant disagreements between the auditor and management; and
   
   (iv) the adequacy of accounting and financial reporting processes of the not-for-profit corporation.

(c) **Evaluate the independent auditor:** consider, on an annual basis, the performance and independence of the independent auditor; and

(d) **Report to the board:** when applicable, put forth a report on the audit committee’s activities to the board.

B. **New Definition and Requirement of Independent Directors**

The Act adds a new definition of independent director and requires that audit committees be comprised solely of independent directors.

An “independent director” as defined in the Act is a director who:

(1) **Is not an employee:** the director is not, and within the last three years has not been, an employee of the not-for-profit corporation or an affiliate thereof, and does not have a relative who is, or within the last three years has been, a key employee of the not-for-profit corporation or an affiliate thereof;

(2) **Has not received more than $10,000 in compensation:** the director has not received, and does not have a relative who has received, in any of the last three fiscal years, more than $10,000 in direct compensation from the not-for-profit corporation or an affiliate thereof; and

(3) **Does not have any interest in an entity that has made or received a sizeable payment:** is not a current employee of, does not have a substantial financial interest in, and does not have a substantial financial interest in.

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7 An “affiliate” is an entity controlled by an organization, in control of the organization or under common control with the organization.

8 A “relative” is an individual’s spouse, domestic partner, child, grandchild, great-grandchild, sibling, half-sibling, ancestor, or the spouse of the individual’s child, grandchild, great-grandchild or sibling.
relative who is a current officer of or has a substantial financial interest in, any entity that has made payments (other than charitable contributions) to, or received payments (other than charitable contributions) from, the not-for-profit corporation or an affiliate thereof, for property or services in an amount that, in any of the last three fiscal years, exceeds the lesser of $25,000 or 2% of such entity’s consolidated gross revenue.

C. New Revenue Thresholds for Financial Reporting Requirements

A charitable organization that has registered with the Attorney General because it intends to solicit contributions from persons or government agencies in New York must file an annual report and statement with the Attorney General, including financial statements for the organization.

1. The financial statements may be **unaudited** for any year in which the organization has gross revenue of less than $250,000.

2. The financial statements must be **reviewed** with a review report from an independent CPA for any year in which the organization has gross revenue of $250,000 or more.

3. The financial statements must be **audited** with an audit report from an independent CPA for any year in which the organization has gross revenue of (a) $500,000 or more until June 30, 2017, (b) $750,000 or more from July 1, 2017, until June 30, 2021, and (c) $1,000,000 or more on or after July 1, 2021 (n.b., the escalating dollar thresholds serve to increase the size that an organization needs to be before it has to incur the incremental cost and burden of obtaining an audit report).

D. Right to Petition the Supreme Court to Evaluate Alleged Wrongdoing

Directors, officers, members or creditors of a not-for-profit corporation are now able to petition for a justice of the Supreme Court to have visitation and inspection rights with respect to the organization’s books and records, if they allege that any of the organization’s directors, officers, members, key employees or agents have misappropriated any of the funds or property of the not-for-profit corporation, or diverted them from the purpose of its incorporation, or that the not-for-profit corporation has acquired property in excess of the amount that it is authorized by law to hold, or has engaged in any business other than that stated in its certificate of incorporation. In such event, the Supreme Court has the power to obtain detailed information from the not-for-profit corporation and to make a determination whether and in what manner wrongdoing has occurred.

3. STREAMLINED ADMINISTRATIVE PROCESSES

A. Elimination of Types of Not-for-Profit Corporations

Under the current law, not-for-profit corporations formed under the NPCL are categorized in one of four categories – Type A, Type B, Type C or Type D – based on the specific purpose of the not-for-profit corporation. For simplicity and clarity, under the Act not-for-profit corporations will be divided into one of only two categories – charitable and non-charitable:

1. **Charitable**: organizations whose purpose is one or more of the following: charitable, educational, religious, scientific, literary, cultural, or prevention of cruelty to children or animals; or

2. **Non-charitable**: organizations whose purpose is not one of the charitable purposes listed above, including those formed for the following purposes: civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry, etc.

On July 1, 2014, existing not-for-profit corporations will be re-categorized as charitable or non-charitable based on their current letter-type, as follows: type B or C corporations, or type D corporations formed for charitable purposes, will become charitable corporations; type A corporations, or type D corporations formed for non-charitable purposes, will become non-charitable corporations.
B. **Allowance of Electronic Communications**

The Act modernizes the NPCL by allowing use of email or facsimile transmission for the following communications:

1. Delivery of notices of meetings to members;
2. Waivers of notices of meetings by members and directors;
3. Consent to corporate actions by vote of the members;
4. Consent to decide in lieu of a board meeting;
5. Distribution of financial statements; and

Whenever electronic communications are used, the message must contain or be accompanied by reasonable indication of authorization by the sender of the message, such as the signature of the member or director.

In addition, the Act now allows the Attorney General to accept financial reports and other mandatory filings via electronic means.

Furthermore, the Act allows directors to take part in a board of directors meeting or a committee meeting via teleconference or videoconference, as long as all board or committee members can hear each other throughout the meeting.

C. **Simplification of Approvals of Substantial Transactions**

1. **Disposition of assets**: Under the current NPCL, there is a two-step approval process for not-for-profit corporations seeking to sell, lease, exchange or otherwise dispose of all or substantially all of their assets: the not-for-profit corporation first seeks court approval for the transaction, and then there may be further review by the Attorney General. The Act permits a streamlined one-step approval process: directly petitioning the Attorney General for approval. In order to seek approval directly from the Attorney General, the petition must include the following:

   - **Sufficient information**: all the information that would be required in a court petition under the previous NPCL;
   - **Solvency statement**: a statement that the not-for-profit corporation is not insolvent and will not become insolvent as a result of the transaction; and
   - **Statement of possible objections**: a statement as to whether any persons have raised, or have a reasonable basis to raise, objections to the disposition transaction, including specific information about the objections and the persons who have or may raise them.

   If a not-for-profit corporation is insolvent or would become insolvent as the result of the transaction, it is not entitled to use the one-step process. A not-for-profit corporation may also seek court approval if the Attorney General does not approve the transaction or if the Attorney General determines that court approval is necessary.

2. **Mergers and consolidations**: The Act permits a one-step process for approval by the Attorney General of proposed mergers and consolidations, similar to that permitted for asset distribution transactions as described above. For proposed mergers and consolidations, the non-profit organization must submit a petition to the Attorney General containing the types of information set forth in clauses (a) and (c) in the preceding subsection, and must file any consents required by
other governmental bodies or other persons under another section of the law (e.g., approval by the applicable regulatory agency that regulates a particular type of non-profit organization).

D. **Reduction of Barriers of Entry for New Not-for-Profit Organizations**

(1) **Improved incorporation process:** Under the current law, the certificate of incorporation of a not-for-profit corporation must include the purpose for which the not-for-profit corporation is being formed and the activities that it will undertake to achieve the stated purpose. The Act eliminates the need to state the activities that the not-for-profit corporation will undertake to achieve the stated purpose, thus streamlining the incorporation process. Additionally, the Department of State is given the ability under the Act to fix minor, non-material errors in the certificates or similar instruments.

(2) **Organizations that include education as a purpose:** The Act eliminates the need for consent from the Department of Education for certain educational organizations. Under the Act, a not-for-profit corporation that will operate a school, college, university, other post-education facility, library, museum or historical society must still obtain consent from the Department of Education before its certificate of incorporation will be accepted for filing. For all other educational organizations, they may be formed by filing their certificates of incorporation, and then they just need to provide a certified copy of that certificate of incorporation to the Department of Education.

E. **Simplification of Committee Types**

The Act dispenses with the current distinction between standing and special committees. Instead, the Act establishes a system of committees of the board or committees of the corporation. The former includes only directors and is the only type of committee that has the power to bind the not-for-profit corporation. The latter can include both directors and non-directors but does not have the power to bind the not-for-profit corporation.

F. **Reduction in Board Approval Requirements for Real Property Transactions**

The Act reduces the vote threshold required for certain real estate transactions, including the purchase, sale, mortgage, lease or other disposition of real property that represents less than all or substantially all of the assets of the not-for-profit corporation. In such cases, the approval of a majority of the board or of a committee authorized by the board is sufficient. If an authorized committee of the board acts in this regard, it must promptly notify the board (in no event later than the next regularly scheduled board meeting).

In cases where the real estate transaction relates to all or substantially all of the assets of the not-for-profit corporation, the approval of two-thirds of the entire board\(^9\) is required (unless there are more than 21 board members, in which case a majority of the entire board is sufficient).

4. **CERTAIN OTHER AMENDMENTS**

A. **Personal Jurisdiction**

Directors, officers, key employees and agents of a not-for-profit corporation are now subject to the personal jurisdiction of the Supreme Court of the State of New York and may be served by the Attorney General.

B. **Agent for Service of Process**

All domestic not-for-profit corporations are required to designate the New York Secretary of State as the agent for the service of process.

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\(^9\) The Act redefines the term "entire board" to mean the total number of directors entitled to vote that the not-for-profit corporation would have if there were no vacancies. For a not-for-profit corporation with a fixed number of directors according to the bylaws, the "entire board" means that fixed number, and for a not-for-profit corporation with a range for the number of directors, the "entire board" means the number of directors within such range that were elected in the most recently held elections.
C. **Prohibition Against Employees Serving as Chairman of the Board**

Employees of a not-for-profit corporation are prohibited from simultaneously serving as the chairman of the board of that corporation.

D. **Court Ordered Indemnification**

Organizations must give advance notice to the Attorney General before applying for court ordered indemnification for directors and officers.

**CONCLUSION**

The Act eliminated or modified a number of burdensome and outdated requirements of the New York Not-for-Profit Corporation Law, thus making it easier to form, operate and govern not-for-profit corporations in New York. The additional oversight and audit requirements provide these organizations with accountability, which should generate greater trust among the members and communities they serve and thereby increase their success in achieving their missions. Under the NPCL, as amended by the Act, not-for-profit corporations are also provided with a level of operational flexibility that the previous law had lacked. As a whole, we view the Act as a welcome and needed modification to the NPCL, and we hope that the summary and recommendations provided in this update are helpful to your understanding of the Act and its implications.

We would welcome the opportunity to answer any further questions about the law and its impact on your organization.

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