



Webinars for Wise Nonprofits: The Role of the Nonprofit Board

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Presented by:

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About Lawyers Alliance for New York

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How is Nonprofit Governance Different?

- Nonprofits must rely on board members for crucial oversight and need to invest in board
- Many regulations and regulators:
 - Federal tax laws and the Internal Revenue Service
 - Not-for-Profit Corporation Law (“NPCL”), including July 2014 changes
 - Employment law & regulatory oversight of corporations generally and/or your specific activities
 - Funders



Nonprofit Boards: Legal Standards and Fiduciary Obligations

- **Duty of Care:** "care that an ordinarily prudent person would exercise in a like position and under similar circumstances."
- Role of third party experts
- Failure to exercise the duty of care?



Nonprofit Boards: Legal Standards and Fiduciary Obligations

- **Duty of Loyalty:** When acting on behalf of the organization, board members must put the interests of the nonprofit before any personal or professional concerns and avoid potential conflicts of interest.
 - Example: A charitable hospital corporation owned a parcel of land adjacent to the hospital. The hospital then sold the land to a corporation owned by one of the hospital's trustees. The trustee then used the land to build an apartment and office building. The court held that these facts constituted a conflict of interest and were sufficient to void the sale
- Example highlights need to understand and comply with conflict of interest policy
- External scrutiny and reputational risk



Nonprofit Boards: Legal Standards and Fiduciary Obligations

- **Duty of Obedience:** Directors and officers are required to perform their duties in accordance with applicable statutes and within the terms of the organization's charitable purpose.
 - Regular maintenance of governance documents
 - Timely making required filings
 - Compliance with internal policies
- Instances in which regulatory compliance failures can result in personal board liability: Employment practices



The Board's Role

- To establish the nonprofit's mission, secure (and maintain) the nonprofit's tax exempt status and approve the certificate of incorporation and bylaws
- To ensure legal and ethical compliance and accountability
- To select and hire the chief executive, support and regularly assess performance
- To ensure adequate funding to fulfill the mission and to oversee finances in order to safeguard resources
- To create a strategic plan and monitor its progress, including program oversight
- To understand the organization's finances and review regular financial reports
- To establish organizational policies
- To enhance the agency's public standing
- To renew the board through continuous education, assessment, and recruitment and orientation of new members



Documenting Good Governance



Certificate of Incorporation

- Certificate of Incorporation is on file with the NYS Department of State
- Purpose statement of Certificate of Incorporation governs what activities your organization may engage in
- Review periodically and update as necessary



Bylaws

- Set of agreed-upon rules and procedures for the internal operations of a not-for-profit corporation
- Should accurately reflect reality and conform to best practices
- Prescribe the decision-making processes of the Board of Directors (the “Board”) and, for membership organizations, the members.
- Governed by the law of the state of incorporation, e.g., the Not-for-Profit Corporation Law (N-PCL) in New York State.
 - In 2013, the NPCL was significantly amended, followed by additional amendments in 2015 and 2017
- Easier to amend than certificate of incorporation, and more flexible



Main Provisions in Bylaws

- **Members (if any)**
- **Directors**
 - Number
 - Qualifications
 - Terms/Removal Quorum and voting
 - Non-compensation
- **Officers**
- **Committees (Board/Corporation)**
- **Amending the Bylaws**
- **Operational Provisions**
 - Contracts
 - Insurance/indemnification



Board Voting

- Board acts as a body, at meetings or by unanimous consent
- **Board action** generally requires vote of majority of directors **present**, unless otherwise indicated in COI, bylaws or statute
- **Quorum** is a majority of the board of directors, unless otherwise indicated in COI or bylaws. In NY:
 - If ≤ 15 directors, need at least $1/3$ of the entire board
 - If > 15 directors, need 5 directors, plus 1 for every 10 additional directors (or fraction thereof) over 15
- **NPRA clarified definition of “entire Board”**
 - The total number of directors entitled to vote, assuming no board vacancies
 - If the bylaws provide for a range of directors, then “entire board” is the number of directors who have been elected or appointed as of the most recent election
- Conference call and **videoconference** participation are permissible, unless restricted in bylaws or COI
- **Proxy voting** (designating a representative to vote) is not permitted



Supermajority Voting

- A supermajority quorum requirement can be adopted only by 2/3 of the voting members (or 2/3 of directors in a non-membership corporation)
- 2/3 of the entire Board is required for **certain decisions**, such as
 - a merger
 - disposition of all or substantially all of the corporation's assets
- Any supermajority voting information should be listed in bylaws for ease of reference
- A **simple majority** is now sufficient for purchase, sale, mortgage or lease of real property
 - **unless** it involves all or substantially all of the assets (in which case a supermajority is required)
 - **Note:** If bylaws still require a supermajority for all real estate transactions, that language will govern



Identifying and Distinguishing Roles: Officers and Directors

- Officers are often – but not always – directors. Typical positions are:
 - Chair/President
 - Secretary
 - Treasurer
- Consider
 - Length of term
 - Responsibilities
 - Compensation
- For employee to serve as Board Chair, 2/3 of the entire board must approve of this and document vote and reason why



Board Committees

- NPRA allows two types of committees:
 - Board Committees (can bind the Board)
 - Committees of the Corporation (usually called Advisory Committees)
- Only Board can create a Board committee.
 - Must have 3 or more directors, and no non-directors.
 - Authority can be in bylaws, COI or Board resolution
 - Participants can be appointed by a majority of a quorum, *not majority of entire Board, and cannot be appointed by the Chair*
- NPRA removed prior distinction between standing and special committees
- Good practice to specifically list in the bylaws the powers that **cannot** be delegated from the full board to a committee



Board Committees

- Board committees may have full Board authority, except that they cannot:
 - Submit to members any action requiring members' approval
 - Fill vacancies in Board or Board committee.
 - Fix compensation of directors for serving on board or committee.
 - Amend or repeal or adopt new bylaws.
 - Amend or repeal resolution of board which by its terms may not be so amendable or repealable.
 - **Elect or remove officers and directors.**
 - **Approve a merger or dissolution plan.**
 - **Adopt a resolution recommending member action regarding certain major transactions.**
 - **Amend COI.**



Executive Committee

- An **executive committee** can meet more regularly than the entire Board or with more ease on an emergency basis
- Appointment of executive committee members usually requires **majority of entire Board**
 - But for a Board of 30 members or more, appointment can be made by at least $\frac{3}{4}$ of the directors present at the time of the vote (so long as a quorum exists)



Committees of the Corporation

- Permitted to have non-board members
- Cannot bind the nonprofit – make recommendations instead
- *Not* subject to the same requirement that majority of entire board elect committee members
- Examples:
 - Annual giving committee
 - Exploration of a strategic alliance
 - Young professional “board”



Amending Bylaws: Common Practical Changes

- Eliminate unduly specific provisions
- Size and composition of Board
- Length, number, staggering of Board terms
- New or evolving Board committees
- Titles and responsibilities of officers
- Indemnification clauses
- For membership organizations, identity of members, e.g., sometimes members and directors are the same people



Amending Bylaws: Common NPRA Changes

- 2013 Nonprofit Revitalization Act (as amended in 2015 and 2017) meant almost all NYS nonprofit organizations needed a governance updated:
 - Conflict of Interest and Whistleblower policies
 - Committee structure and terminology
 - Audit Committee and thresholds
 - Modernized communications
 - Definition of “entire Board,” “independent director,” “key person”
 - Approval process for major transactions



The Board's Role in Financial Oversight



Form 990

- Annual reporting obligation to the IRS.
- Informational tax form filed by tax exempt organizations.
- **Filing deadline:** by the fifteenth day of the fifth month following the end of the organization's fiscal year.
 - **Caution!** Failure to file 3 consecutive Form 990s -> automatic revocation of tax-exempt status
- Public relies on information contained in Form 990.
- Different Form 990s filed based upon “gross receipts” but generally disclose:
 - Financial Disclosure
 - Governance Procedures
 - Executive Compensation and Interested Party Transactions
 - Lobbying



Form CHAR 500

- Organizations that receive, or intend to receive, more than \$25,000/year in charitable contributions in New York must file form CHAR 410 (filed online) to register with the New York Attorney General Charities Bureau for charitable solicitation
- Organizations required to register must file Form CHAR 500 each year
 - Accompanied by a CPA “review report” or audit report” depending on annual gross revenue
- Must be filed within 4 ½ months of the organization’s year end
- Form CHAR 500 is available to the public at www.charitiesnys.com



Audit Thresholds

- For annual reports filed between July 1, 2017 until June 30, 2021:

Annual Revenue	Required Filing
At least \$250,000 but not more than \$750,000	Independent CPA's <u>review</u> report
More than \$750,000	Independent CPA's <u>audit</u> report

- For annual reports filed on or after July 1, 2021:

Annual Revenue	Required Filing with NY AG
At least \$250,000 but not more than \$1,000,000	Independent CPA's <u>review</u> report
More than \$1,000,000	Independent CPA's <u>audit</u> report



Independent Directors: Role in Overseeing Audit

- “Independent Directors” relevant only for those nonprofits required to file CPA’s review report or full audit:
 - For such organizations, audit requirements can be handled by the **whole board or delegated to an audit committee**, but regardless:
 - **Only Independent Directors** can oversee accounting and financial reporting processes and the audit
 - If delegated to an Audit Committee, Audit Committee must be comprised only of Independent Directors
 - Independent directors must retain the auditor, oversee the audit, and review results of the auditor’s findings



Audit Committee

- A corporation required to file a CPA audit:
 - must have an audit conducted by an independent CPA
 - Board or designated Audit Committee must oversee accounting and financial reporting processes and audit, including:
 - Annually retain or renew the retention of the auditor
 - After the audit: review the results and any related management letter with the auditor
- Only independent directors may participate



Audit Committee

- Additional Board duties of a corporation with over \$1 million in revenue during the prior or current tax year:
 - Before the audit: review scope & planning of the audit with the auditor
 - After the audit: review & discuss with the auditor:
 - any material risks & weaknesses in internal controls
 - any restrictions on auditor's activities or access to information
 - any significant disagreements with management
 - adequacy of the accounting & financial reporting processes
 - Annually consider auditor's performance and independence



Other Financial Policies

- Investment Policies
 - For any organization holding investment accounts
 - Include factors required by New York Prudent Management of Institutional Funds Act (“NYPMIFA”)
- Internal Financial Controls
 - NY AG’s publication “Internal Controls and Financial Accountability for Not-For-Profit Boards”



Conflict of Interest Policies



What is a Conflict of Interest?

- A conflict of interest arises where a director, officer or other key person has an outside interest or relationship that conflicts or may conflict with his/her ability to act strictly in the best interests of the organization.
- Some common scenarios:
 - Setting executive compensation
 - Voting on a commercial transaction in which an “insider” has a financial interest



Conflict of Interest Policy

- Required by New York law
 - All NY nonprofits must have a **conflict of interest policy**, laying out how to identify and address ***related party transactions*** (may also cover other, non-financial conflicts)
 - Depending on the facts, a failure to make proper disclosures may lead the Attorney General to charge that there has been a breach of the duty of loyalty.
- Not required by federal law, but Form 990 asks about it



Conflict of Interest Policy: NY-Required Contents

- A **definition** of “conflict of interest”
- **Procedures** for disclosing a conflict to the board (or committee of the board)
- Procedures for disclosing, addressing and documenting **related party transactions**
- 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
- A requirement that directors submit **written conflict disclosure statements** before initial election and, thereafter, annually



Related Party Transactions

- **Related Party Transaction:** a transaction/agreement where
 - A “related party” has a financial interest; and
 - The corporation or its affiliate is a party
- A **Related Party** is:
 - Director, officer, or **key person** of the corporation or an affiliate;
 - A relative of any of the individuals in (1); or
 - Any entity in which any of the individuals described in (1) or (2) has a 35%+ ownership interest, or in the case of partnership/professional corporation, a direct or indirect interest exceeding 5%
- **Relative:** A spouse, domestic partner, ancestor, child (incl. adoptees), grandchild, great grandchild, sibling (incl. half siblings), or spouse or domestic partner of a child, grandchild, great grandchild or sibling



Related Party Transactions (cont'd.)

- **Key Person**

- has responsibilities or exercises powers or influence over the corporation as a whole, similar to that of directors/officers;
- manages the corporation or a substantial portion of the activities, assets, income, or expenses of the organization; or
- controls or determines a substantial portion of the corporation's capital expenditures or operating budget



Related Party Transactions – Who Reviews and Approves Them?

- Entire board
- A committee of the board, as authorized by the board (e.g. Audit Committee)



Related Party Transactions: Exceptions

- The following are **not considered** related party transactions:
 - Transactions where the transaction itself or the related party's financial interest in the transaction is de minimis
 - Transactions that would not usually be reviewed by the board in the ordinary course of business and is available to others on the same or similar terms
 - Transactions that benefit a related party solely as a member of a class of charitable beneficiaries, where the benefit is available to all similarly situated members of that charitable class on the same terms



Can the Nonprofit Enter into a Related Party Transaction?

- If a related party has a **substantial financial** interest in a transaction, the board/committee must:
 - *consider alternative transactions to the extent available before entering into the transaction*
 - *only approve related party transactions that are fair, reasonable, and in the best interest of the corporation (by at least a majority vote of the directors or committee members present), and*
 - *contemporaneously document in writing the basis for approval*



Conducting the Meeting

- A related-party director may not participate in deliberations or voting regarding the related party transaction
 - but a quorum will not be lost if one or more directors recuse themselves because of the related party transaction
- The board/committee may request that the related party be present to provide information before deliberations/voting begin



Annual Disclosure Requirement

- Procedures for identifying, disclosing, addressing, and documenting related party transactions
- Before a director is initially elected, and annually thereafter, the director must complete, sign and submit a written statement identifying:
 - any entity of which the director is an officer, director, trustee, member, owner, or employee that has a relationship with the organization, and
 - any transaction in which the organization is a participant and in which the director might have a conflicting interest



Retroactive Approval of Related Party Transactions

- A limited statutory defense is available for related party transactions that were not properly authorized in the first instance
- To benefit from defense, the related party transaction must be ratified before the nonprofit receives any request for information by the Attorney General concerning the transaction
- Must document in writing the failure to consider the related party transaction in the first instance, the basis for approval of the related party transaction, and adopt corrective procedures to ensure future compliance



NY Attorney General Enforcement Powers

- NY AG has power to commence proceedings to:
 - Enjoin, void or rescind any actual or proposed related party transaction, including a compensation arrangement, if it violates any law or is otherwise not reasonable or in the best interests of the organization
 - Obtain damages, restitution, removal and/or an accounting, and
 - Obtain double damages if there was willful and intentional conduct



Excess Benefit Transactions

- Federal tax laws and regulations impose excise taxes (a/k/a “intermediate sanctions”) on disqualified insiders of public charities benefiting from “excess benefit transactions”
- An “excess benefit transaction” is any transaction in which an economic benefit is provided by an exempt organization to a **disqualified person** if the value of the benefit exceeds the value of the consideration
 - Reasonable compensation, i.e. what would ordinarily be paid for like services under similar circumstances, is not excess benefit
- In some cases, board members may incur personal liability



Excess Benefit Transactions: Analysis

- A **disqualified person** is any person during a five-year look-back period who exercised **substantial influence**.
- Facts and circumstances indicating substantial influence
- First tier penalties, second tier penalties (if not corrected within taxable period), and 10% tax on organization managers who knowingly participated in the EBT



RPTs vs. Excess Benefit Transactions

- New York vs. Federal (NYAG vs. IRS)
- Discovery/Whistleblower Rule vs. Self-Declaration/Audit Rule
- Removal, Rescission, Double Damages vs. Excise Tax
- “Related Party” ≠ “Disqualified Person”
- Procedure & Reasonableness vs. Effective Prohibition



Other Considerations



Additional Policies to Consider

- Executive Compensation
- Personnel/Employment
- Nepotism Policy
- Investment Policies
- Gift Acceptance Policies
- Document Retention
- Financial Control Policies
- Succession Planning
- Emergency Preparedness



Personal Liability for Board Members?

- Business judgment rule generally applies
- Personnel and employment practices are points of vulnerability
- **Directors and Officers Insurance**
- Statutory protection for uncompensated board members (NPCL 720-a) and Federal Volunteer Protection Act
- Special challenges of attorneys serving on nonprofit boards:
 - Possible conflicts between attorney and director roles
 - Imputed conflicts of interest for others at firm
 - Protection/loss of attorney-client privilege
 - Insurance coverage: malpractice versus D&O
 - Duty of competence that lawyer owes to client
 - Independent judgment issues.



Questions?

**Resource Call Hotline
(212) 219-1800 ext. 224**