



**NEW YORK
CITY BAR**

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**REPORT ON LEGISLATION BY THE
COMMITTEE ON NON-PROFIT ORGANIZATIONS**

S.2138

Senator Kruger

AN ACT to amend the not-for-profit corporation law, in relation to duty of directors and available relief for breach thereof.

THE BILL IS APPROVED WITH SUGGESTED MODIFICATION

The Committee on Non-Profit Organizations of the Association of the Bar of the City of New York endorses Senate bill 2138 and urges its enactment into law. The Committee believes that this bill is an important step towards removing barriers faced by nonprofits, especially smaller nonprofits, when trying to recruit volunteer board members.

The bill would add a new paragraph (d) to Section 402 of the Not-for-Profit Corporation Law (N-PCL) to give non-profit organizations the option of limiting or entirely eliminating the liability of directors to the corporation or its members for damages for any breach of duty in such director capacity. Directors would remain personally liable, however, if they are found, after an adjudicated proceeding, to have engaged in acts or omissions that (i) were in bad faith, (ii) involved intentional misconduct or a knowing violation of the law, (iii) resulted in the director's personally gaining a financial profit or other advantage to which such director was not legally entitled, or (iv) violated Section 719 of the N-PCL.¹ There is an exception for healthcare corporations organized under Article 43 of the Insurance Law. The bill would also add a conforming amendment to Section 720 of the N-PCL.

To elect the benefits of this provision a corporation would need to include a waiver or limitation of liability provision in its certificate of incorporation or in a later amendment to such certificate.

New York law currently gives directors and officers of certain not-for-profit corporations only limited protection against personal liability -- under Section 720-a of the N-PCL unpaid directors and officers of Section 501(c)(3) charities are excused from liability except in cases of gross negligence or intentional harm. Section 720-a, however, does not apply to any claim by the nonprofit, the Attorney General or certain other persons in the right of the nonprofit under N-PCL Section 720 (including claims (1) for an accounting for (a) neglect of, or failure to perform,

¹ N-PCL 719 imposes liability on directors for the benefit of the nonprofit's creditor, members or beneficiaries or the nonprofit itself as a result of making (a) distributions not allowed by the N-PCL, (b) redemptions contrary to the N-PCL, (c) payments to subvention or bond holders in excess of allowed payments, (d) distributions that are not allowed, or not paying known creditor liabilities, in connection with dissolution, or (e) loans to directors or officers.

or other violation of duties in the management and disposition of corporate assets or (b) acquisition by such person, transfer to others, or loss or waste of corporate assets due to neglect of, failure to perform or other violation of duties; (2) to set aside an unlawful transfer of corporate assets where the transferee knew of the unlawfulness; or (3) to enjoin an unlawful transfer of assets); to claims under Section 719; or to any action or proceeding by the Attorney General or by a trust beneficiary. As written, Section 720-a generally exculpates volunteer officers and directors only from liability for third party claims (*e.g.*, tort claims, which are usually claims where the director is sued along with the nonprofit for an action which he took in an official capacity) and does not cover paid directors or directors of noncharitable nonprofits. Section 720-a does not apply to breach of duty claims, which can only be brought by the nonprofit (or someone claiming in the name of the nonprofit, such as the Attorney General) or members of a nonprofit.

Most states, including Delaware, have long included broader director exculpation clauses, on the grounds that people are less willing to participate at the board level if they are taking on significant liability risk. The lack of a full director indemnification provision is one reason why many new New York-based nonprofits are being formed under the laws of Delaware or other states with such provisions. If adopted, S.2138 will bring New York law into conformity with the laws in these other states. Indeed, S.2138 will also bring the N-PCL into conformity with the New York Business Corporation Law (BCL), which has included a similar exculpation provision, Section 402(b), since 1987 (we note, however, that the BCL provision states that liability for acts or omissions prior to adoption of such exculpation provision cannot be eliminated or limited).

We believe that limiting the personal liability of non-profit directors, except in cases of egregious or unlawful conduct, will eliminate an obstacle to recruitment, especially by smaller organizations that cannot afford directors and officers (D&O) insurance. For example, one committee member is personally aware that Head Start programs are legally required under federal law to recruit licensed attorneys for their boards, but several programs that lack D&O liability insurance have been unable to do so. Allowing existing nonprofits to adopt such exculpation provision gives the broadest possible protection to non-profit directors, which should aid in board recruitment and retention.

To the extent that there may be a fear that lack of full personal liability might encourage unlawful behavior, we believe that the bill includes adequate protections to ensure that egregious behavior is still unprotected. Furthermore, the new provision does not limit the right of the nonprofit or the Attorney General to bring actions other than for damages, meaning that the nonprofit or the Attorney General can still seek injunctive relief or other equitable remedies even in cases that do not fall within the exemptions from coverage of this bill. Organizations that are concerned about adverse consequences of any limitation of personal liability of directors always retain the option of not including such a provision in their certificate of incorporation. We also note that nonprofits that have members must obtain the consent of such members to amend their certificate of incorporation, giving such members the right to reject any proposed change.

We understand, however, that there may be a concern that the bill may exculpate paid directors from claims that they received excessive compensation. We also understand that nonprofits that can afford to pay their directors should have adequate financial resources to purchase director's and officer's liability insurance. Accordingly, we would not oppose a change

to the legislation to limit its protection to directors who are serving without compensation (a requirement for the exculpation provisions of Section 720-a). We would also support addition of a provision similar to the provision that appears in the corresponding BCL section to the effect that liability for acts or omissions prior to adoption of such exculpation provision cannot be eliminated or limited.

Strong boards including members with appropriate professional backgrounds are crucial for the survival of non-profit organizations. Making non-profit board service more attractive by eliminating a major drawback to service increases the pool of sophisticated individuals willing to serve on non-profit board.

For the reasons noted above, the Committee on Non-Profit Organizations endorses the bill.

Recommended Modification. The Committee recommends inclusion of language in the bill (or elsewhere in the legislative history) confirming that the benefits of this new paragraph (d) can be adopted by amendment of the certificate of incorporation and that such amendment would not require any consents of any state agencies or a justice of the supreme court.

Eliot P. Green, Chair
Patricia J. Diaz, Non-Voting Secretary

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* member of subcommittee reviewing proposed revisions to the Not-for-Profit Corporation Law

** did not take part in the consideration or approval of this report

*** opposed

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