NEW YORK CITY BAR

COMMITTEE ON NON-PROFIT ORGANIZATIONS

March 6, 2013

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Jason Lilien, Esq.
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Office of the Attorney General
120 Broadway, 3rd Floor
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Re: Attorney General Program Bill - S.B. 7431 (2012 session)

Dear Mr. Lilien:

On behalf of the Committee on Non-Profit Organizations of the New York City Bar Association, we write to comment on the Attorney General's Program Bill, S.B. 7431, the Non-Profit Revitalization Act, which was introduced in 2012. We wrote an initial comment letter to you on September 21, 2012, and we appreciate your openness to hearing further from us and other representatives of the nonprofit community.

We are writing now to flesh out the concerns and recommendations that we expressed in our earlier letter. We understand that the Attorney General may be revisiting the 2012 bill in anticipation of introducing a new version in 2013, and we offer these comments in that context and in the hope that the 2013 bill might be strengthened by our suggestions.

By way of background, the Committee on Non-Profit Organizations (NPOC) is a diverse 42-member committee of the New York City Bar Association.[1] Some of us are law firm attorneys representing nonprofits, some are in-house counsel for charitable organizations, and a few are legal scholars. We represent multi-million dollar institutions and tiny charities, institutions in many parts of the charitable sector, and institutions that have been serving New York for more than a century as well as groups now seeking to incorporate as non-profits in New York or elsewhere.

[1] Members of the Attorney General's staff have long contributed to the work of the Committee, but the current Charities Bureau representative on the Committee has not participated in developing this letter.

Our comments seek to address the implications of the proposed changes for these diverse charities, with particular concern for the new burdens that they might place on smaller and more modestly-sized charities.

We fully support the bill's stated goals, reduction of "unnecessary and outdated burdens on non-profits" and "enhanced nonprofit governance and oversight." In our view, many of the proposed amendments further those goals, but as we explain below, we are concerned that some will substantially increase the burdens on non-profits, requiring them to focus significant time and resources on technical compliance obligations without a significant payoff in enhanced governance and oversight. While we work with our clients to develop and meet "best practices," we question whether best practices can or should be legislated, especially if the same practices are to be required of all types and sizes of organizations.

As we indicated in our earlier letter, we applaud the efforts of the Charities Bureau and the Attorney General's Committee to Revitalize Nonprofits to simplify and modernize aspects of New York's Not-for-Profit Corporation Law (N-PCL) and other laws applicable to nonprofits. We welcome provisions that would, for example, eliminate unhelpful corporate "types" and substitute more commonsensical "purposes" (most of sections 1, 2, 3 and 10 and other conforming amendments), streamline procedures for forming corporations (including sections 4 and 5) and for approving real estate transactions (section 24), and expressly permit the use of electronic communications for corporate proceedings (sections 32-35, and 39-40). We have attached some suggested technical changes that might further simplify some of these aspects of the law without compromising the Bureau's important oversight and enforcement goals.

As we stated last year, we are concerned that many New York lawyers now encourage non-profit clients to organize in more charity-friendly states to avoid the extraordinary and sometime capricious burdens of current New York law and procedure. We believe that the streamlined procedures the Attorney General has proposed might persuade lawyers to reconsider the benefits of forming nonprofits outside of New York.

We are concerned, however, that some of the governance and oversight proposals in the bill are so broad and burdensome that they would weigh heavily against choosing to incorporate in New York and, perhaps more significantly, place extraordinary burdens on existing New York charities, including many that do not have the resources to meet those new requirements. We are concerned that some of these new requirements will force charities to refocus energy and resources best used for their charitable purposes on overly detailed compliance obligations.

The bill as introduced in May 2012 appears to require many New York charities (and not merely a small number of charities with significant resources) to adopt conflict of interest and whistle blower policies compliant with very specific requirements and follow detailed and unnecessarily onerous procedures for reviewing <u>all</u> related party transactions (no matter how minor or obviously advantageous to the charity), <u>all</u> potential conflict of interest decisions (no matter how inconsequential) and <u>all</u> decisions regarding compensation of officers and the five most highly compensated key employees (no matter how modest that compensation may be). We oppose such

provisions as they are currently drafted.

We address certain of these individual issues in more detail below, but we have a overarching set of concerns applicable to most of the bill's governance proposals:

- These proposed requirements are, to our knowledge, unique among the states. While the Internal Revenue Service encourages similar policies and procedures by requiring disclosure and providing safe harbors, it does not require that charities meet such detailed requirements. If the changes proposed in the May 2012 bill were adopted, many New York charities would have a significant set of new obligations that are not borne by charities incorporated in any other state. We encourage the Attorney General to propose safe harbors rather than absolute requirements.

- While some of the proposed requirements apply only to charities with more than specified budgets or numbers of employees, the thresholds are quite low, so that relatively modest-sized charities might, for example, be compelled to devote substantial time and resources to elaborate reviews of the compensation of even those officers and key employees whose compensation is obviously well below market rates. If the Attorney General continues to believe that it is necessary to impose additional procedural requirements, we encourage the Attorney General to consider placing the requirements only on the largest charities with the possibility of phasing them in for mid-sized entities over time, while continuing to exempt smaller entities.[2]

- The proposed requirements do not have materiality standards and, indeed, eliminate the existing N-PCL section 715(a) requirement of a "substantial financial interest." Thus, as we noted in our prior letter, the proposed revisions to sections 715 and 715-a would appear to require a college to perform a full review before so much as buying a book written by the President or a highly compensated faculty member. As the Attorney General notes in the publication *Right from the Start: Responsibilities of Directors of Not-for-Profit Corporations:* "the board is generally not involved in the day to day activities of the organization." The new rules, however, would appear to require all directors to do just that. Similarly, transactions that are truly *de minimis* or patently favorable to the nonprofit should not be subject to wasteful "hoop jumping" requirements.

- The amendments frequently require an act of the full board and prohibit reliance on committee determinations. Requiring committees to report their actions to the full board is appropriate but requiring duplicative levels of approval is wasteful and unlikely to yield

[2] While the Committee is not in complete agreement on where the lines should be drawn, we suggest that the Attorney General consider treating nonprofits with over $10,000,000 in revenue or over 100 employees as "large" and nonprofits with less than $1,000,000 in revenue as "small" and the other nonprofits as "mid-sized." If the Attorney General's office concludes that mid-sized nonprofits should become subject to some of the new governance requirements, we urge the Attorney General to provide a period of years (perhaps five) after implementation for the large nonprofits so that standard policies and Charities Bureau guidance would have been developed and the burden on the mid-sized charities would be less onerous. There should also be a reasonable phase-in period for the larger charities that would be initially subject to any new requirements.

significant benefits. Indeed, the requirement of an essentially *de novo* review by the full board undercuts the important benefits of streamlined and generally more nimble committee structures.

- Many proposed new definitions appear to be based on existing regulations (notably the Internal Revenue Code) but with slight changes. These small differences significantly increase the administrative burden of compliance, with little if any discernible benefit. To the extent possible, the definitions should be consistent so that nonprofits can more easily ensure compliance with both state and federal regulations on the same basis.

We address the major new regulatory burdens in turn:

Audit Oversight (proposed section 712-a). The Committee would support a requirement that large charities appoint audit committees if the proposal (i) is limited to charities with over $1,000,000 in revenue, (ii) provides charities with a reasonable period of time in which to adopt a charter and appoint a committee, (iii) permits charities to assign this responsibility to alternative committees of independent directors, and (iv) provides for a phase-in period under which the largest charities are the first required to adopt these provisions and mid-sized charities have additional time to do so. To avoid undue burden on nonprofits with small boards, the provision should also permit all independent members of the full board to perform the functions of an Audit Committee.

Executive Compensation Oversight (proposed section 712-b). We support the goal of board oversight of executive compensation, but we are concerned that the specific amendments take a "one size fits all" approach that is inappropriate for many charities, particularly those that pay clearly modest (and often significantly below-market) salaries.

- We respectfully submit that the focus should be on the amount of compensation paid rather than the process by which it is determined. Internal Revenue Code Section 4958 already encourages the procedures the bill would mandate. But if the compensation is manifestly reasonable, the failure to follow technical procedures should not give rise to liability.

- Requiring elaborate procedures even when there are no highly compensated employees requires charities to waste resources on unnecessary procedures and consultants. We understand the Attorney General's position that non-profit corporations can do their own benchmarking, but we know from experience that many boards feel obligated to retain consultants to ensure that they are meeting the detailed requirements of the new law and insulate board members from liability. These resources are better spent on the charities' missions; consultants' fees will not buy improved oversight.

- Similarly, boards should continue to be able to delegate responsibility for reviewing and approving executive compensation to committees of independent directors. Boards, particularly larger boards, act through committees so that they make more efficient use of their members, who can develop expertise in, and devote necessary time to, particular

areas of governance. Requiring the full board to take direct responsibility for executive compensation effectively eliminates the utility of a compensation committee.

- We urge adoption of a materiality standard modeled on that of the IRS 990, which limits disclosure requirements to individuals paid more than $150,000 annually. (We also support defining key terms, such as independence, key employees, and relatives, by reference to the definitions of those terms used by the IRS.) Requiring detailed review of the salaries of those who make less than this threshold places an unnecessary burden on directors and seems likely to require them to focus undue effort on scrutinizing modest compensation.

Related Party Transactions (proposed sections 715). We agree that related party transactions and other conflicts of interest are serious matters that require board or committee oversight. We would support a requirement that material related party transactions be disclosed to the full board, but we are concerned that the exhaustive procedures set forth in the draft amendments would waste board time with immaterial transactions and arrangements that obviously benefit the charity, distracting the board from more critical work. The proposed amendments as written would prohibit any related party transaction, no matter how immaterial or beneficial absent elaborate board review including examination of alternative transactions and a two-thirds vote of the entire board.[3]

We encourage the Attorney General to consider instead adopting a rebuttable presumption under which independent review of transactions would provide the charities with some protection, but boards would not be required to review minor or clearly beneficial transactions merely to ensure compliance with technical requirements.

Should the Attorney General conclude that board review of related party transactions is required, we recommend that such required review only apply to material transactions. As we have noted, board review should not be required for small or routine transactions like the purchase of a library book or a transaction where a related party is waiving fees or charges. Similarly, the purchase of goods or services at evidently below market prices should not require review.

We also urge the Attorney General to remove the requirement that the board affirmatively consider alternative transactions. Consideration of alternatives will sometimes be an appropriate part of a board or committee's review of an interested party transaction, but there are many situations in which such review is impractical (where, for example, the transaction involves the acquisition of a unique good or service or the provision of needed services at clearly below market prices or there is an urgent need for the goods or services) or unnecessary (as where the transaction was competitively bid or is otherwise patently in the charity's best interests). Procedure for the sake of procedure benefits neither charities nor the public.

We also urge the Attorney General to let charities continue to rely on committees of independent

[3] We have long noted the difficulties of imposing such high levels of director approval, especially since many nonprofits have large boards with quorums as low as one-third.

directors to vet and, where appropriate, approve related party transactions. Requiring review by the full board is less likely to result in truly careful scrutiny than assigning this responsibility to a dedicated committee. Such an approach also limits charities' ability to divide board work among committees.

Whistle Blower Policies (proposed section 715-a and related changes). Existing New York law (including Labor Law §740) provides some whistleblower protections; whistleblowers are also protected by certain provisions of the Sarbanes-Oxley Act. We are concerned that the detailed requirements of the bill would place undue burdens, particularly on smaller charities. We urge the Attorney General to rely instead on existing law. Should the Attorney General conclude that some further whistleblower protections are necessary, we submit that the employee threshold for requiring such protections should be substantially higher than five and suggest fifty employees, a common threshold for many employee protections (such as the Family and Medical Leave Act).

Again, we appreciate your willingness to consider the views of charitable organizations and look forward to continuing to work with you to make New York law hospitable to nonprofits while encouraging and promoting best governance practices for nonprofits.

Very truly yours,

David W. Lowden

Suggested Technical Corrections to AG N-PCL Reform Bill

Nonprofit Organizations Committee of the New York City Bar Association

March 6, 2013

This chart sets out technical comments on existing provisions of the N-PCL that are proposed for revision by the AG bill. The chart does not include comments on new governance provisions proposed by the AG, as to which our general comments are set forth in the accompanying letter, or changes on sections not otherwise proposed for revision.

Section	AG's Amendment	Comment
102	Adds language in new paragraph 6-A to the effect that if the bylaws say the board may consist of a range between a minimum and maximum, the entire board shall be the number of directors elected at the last election of directors	We applaud the proposed change, but additional changes would more fully address the issue: (a) Section 702(a) limits the right to have such a bylaw provision to corporations with members who have approved such bylaw provision. Section 702(a) should be amended should allow any corporation's bylaws to authorize a range of board members (b) As the N-PCL authorizes in section 704, some nonprofits elect board members for multi-year terms, thus electing only one class each year. Additionally, directors can die, resign or be removed and the board can vote to increase the size of the board. To address these cases, words to the following effect should be added: "...(PLUS, IN THE CASE OF CLASSIFIED BOARDS, DIRECTORS FROM CLASSES NOT UP FOR RE-ELECTION), AS ADJUSTED TO REFLECT ANY DEATHS, RESIGNATIONS, REMOVALS OR PRIOR ELECTIONS)." (c) If the bylaws allow the board to fix its size within a range, then the "entire board" should be the size so fixed by the board; the proposed provision that sets the "entire board" at the number of directors elected at the last election should only apply if the board has not fixed its size within the range.

Section	AG's Amendment	Comment
	Adds new paragraph 9-B, defining "non-charitable purposes"	The definition requires the non-charitable purposes to be "non-business" (in one instance) and "non-pecuniary" (in another). We suggest using the same term in both instances.
	Adds new paragraph 21, defining "independent director"	The definition excludes any person who received payments from or made payments to the nonprofit of more than $10,000 over the past three years. Charitable contributions and expense reimbursements should be excluded from the sum.
404	The Commissioner of Education's consent would not be required under paragraph (d), but notice would be given within 10 business days after receipt of confirmation of formation, as is the case now with nonprofits described in paragraph (b)(2).	Paragraph (b)(2), regarding procedures for child care entities, should be conformed with the new wording of paragraph (d) to require the notice be given within 10 "business" days after the corporation receives confirmation of filing.

Section	AG's Amendment	Comment
509	Allows the purchase of real property upon approval of a "majority of the directors of the board" or board committee but requires approval of two-thirds of the entire board if the property would constitute substantially all of the assets. Separate but similar requirements relate to the sale, mortgaging or leasing of real estate.	The phrase "majority of the directors of the board or a committee authorized by the board" is not used elsewhere in the statute. We suggest, instead, "a majority of the directors in attendance at a meeting of the board or a committee authorized by the board." If a majority of the entire board (the customary phasing used in the N-PCL) or committee must approve, then this should be rephrased as "a majority of the entire board, or a majority of all members of a committee authorized by the board,...". Continuing the current two-thirds approval requirement for sales of substantially all the assets makes sense; two-thirds approval for purchases if the property would constitute substantially all the property does not seem to be so important an act as to require such very large approval level. We note that at the time of formation of a corporation, a small piece of property may constitute the bulk of the nonprofit's assets, even though it will not after the nonprofit commences operations, and nonprofits may inadvertently have such purchase approved by a mere majority vote because the transaction does not seem significant. We suggest that purchases only require the vote of a majority of the directors or committee members in attendance, or a majority of the entire board or committee as described above.
605 and 606	Allows notice to members by e-mail.	Notice by facsimile should also be allowed as there are some directors with fax machines but no email.
702	Moves the definition of "entire board" to the definition section.	As noted with respect to Section 102, change the second sentence to read: "Subject to such limitation, such number may be fixed by the bylaws or by action of the members or of the board under the specific provisions of a bylaw allowing such action or be any number within a range between a minimum and maximum set forth in the bylaws."

Section	AG's Amendment	Comment
712	The distinction between "standing" and "special" committees would be eliminated, thus requiring all committees to meet the requirements for "standing" committees.	This change would require that all board committees have at least three members approved by a vote of the majority of the entire board. Currently, only standing committees must have three members, each of whom is named by the majority of the entire board. • While any executive committee should have at least three members, there may be circumstances in which a smaller committee is appropriate, consisting of two members or even one member. If all committees must have three members, smaller board will find it difficult to act through committees. • Having the Board name the members of committees is appropriately required for the executive committee and other committees that act with the authority of the board. But many other committees act in an advisory capacity or in a very limited area. It is appropriate for such committees to be appointed in any other manner described in the by-laws, such as by the Chair or by a majority of those present at a meeting. Accordingly, we would propose revising this section to read: "If the certificate of incorporation or the by-laws so provide, the board, by resolution adopted by a majority of the entire board OR AS OTHERWISE AUTHORIZED IN THE BY-LAWS (*PROVIDED, HOWEVER*, THAT ALL MEMBERS OF ANY EXECUTIVE, AUDIT AND COMPENSATION COMMITTEES AND ANY OTHER COMMITTEES WITH THE AUTHORITY OF THE BOARD MUST BE APPROVED BY THE BOARD OF DIRECTORS), may designate from among its members an executive committee, and other [~~standing~~] committees. [~~each consisting of three or more directors and~~] ANY EXECUTIVE COMMITTEE SHALL HAVE AT LEAST THREE DIRECTORS. Each of SUCH COMMITTEES [~~which~~], to the extent provided in the resolution or in the certificate of incorporation or by-laws, [~~shall~~] MAY have all the authority of the board, except that no such committee shall have authority as to the following matters :

Section	AG's Amendment	Comment
	Language is added to confirm that committees of the corporation do not have authority to bind the board.	The new language is appropriate, but the provision also continues the current provision which states that the procedure for appointing members of committees of the corporation should be the same as that for election of officers. Generally the by-laws state that officers shall be elected by the board and few corporations include in their by-laws the optional provision of Section 713 available to nonprofits with members of giving the president the power to appoint subsidiary officers. It is often appropriate for an officer of the corporation (or the chairman of such committees) to appoint the members of committees that are not committees of the board and the law should reflect the flexibility with which non-board committees may be appointed and used. Accordingly, we would suggest amending the second sentence of paragraph (c) to read: "Such committees OF THE CORPORATION may be elected or appointed in the same manner as officers of the corporation OR AS OTHERWISE SET FORTH IN THE BY-LAWS, BUT NO SUCH COMMITTEE SHALL HAVE THE AUTHORITY TO BIND THE BOARD.
1003	Makes changes regarding certificate of dissolution	In the interests of consistency (see section 404, above), subsection (b)(1) should require notice to the Commissioner of Education rather than the Commissioner's consent to dissolution. This would track the language applicable to child care charities (since the formation language for both would now be the same).
Executive Law 171-a	Exempts grant writers from treatment as fund raising counsel	The provision should also explicitly exempt individuals who advise not-for-profit corporations as to logistical and other non-financial aspects of charitable benefits (such as event planners).
Education Law 22	Allows mergers of education corporations; currently only consolidations are allowed	Section 216 of the Education Law[1] should also be amended to be consistent with the changes to Section 404 of the N-PCL regarding education department consent/notice. We understand that NYSED believes that its consent is required under this provision, as well as the N-PCL. We would suggest adding, "except as other

[1] Which states: "No institution or association which might be incorporated by the Regents shall, without their consent, be incorporated under any other general law."