14-04

COMMITTEE ON NON-PROFIT ORGANIZATIONS

S. 7219 **Senator Leibell**
A. 11292A **M. of A. Brodsky**

AN ACT to amend the Not-for-Profit Corporation Law, in relation to protections against financial fraud and abuse and to repeal certain provisions of such law relating thereto.

THIS BILL IS APPROVED

This bill will repeal present section 715 of the Not-for-Profit Corporation Law ("N-PCL"), "Interested directors and officers," and replace it with new provisions governing transactions between a not-for-profit corporation and its officers and directors. The new statute provides that such a transaction may be voided or modified by the corporation or the Attorney General unless the interested party and the approving directors affirmatively establish that the transaction is fair and reasonable to the corporation at the time of the transaction. It further provides that the Attorney General may seek restitution to the corporation (plus interest) from the parties to the transaction if it was not fair and reasonable. The bill also includes new voting requirements for approving of compensation to officers and directors.

The Committee is aware that some of the worst abuses the non-profit sector arise as a result of unfair insider transactions. These abuses occur in only a small percentage of organizations operating in New York. Nevertheless, when they do occur, the available remedies may not be adequate to protect the organization and the public. If the present standards for approval of the transaction, which are procedural and not substantive, are met, the unfairness of a transaction is not a basis to void it, and the corporation or the Attorney General can seek redress only by asking for damages for corporate negligence and waste or removal of the negligent directors (N-PCL §720).

The bill gives the Attorney General the explicit authority to void unfair transactions and seek restitution from the parties, while protecting organizations by laying out a procedure for prior substantive review by the Board to approve insider transactions. This procedure, which creates a presumption that the transaction is fair and reasonable, is essentially the same as one already applicable to many Type B not-for-profit corporations under Internal Revenue Code §4958, so there is no additional undertaking required for those organizations to satisfy the presumption. The extension of the applicability of the process (which is not mandatory in any case) to other not-for-profit corporations provides them with guidelines as to good practice in this area and the opportunity to take advantage of the presumption. We approve of these provisions.

The bill also sets out voting requirements for approval of compensation for officers and directors, which reverse the present requirements that call for a greater vote of the Board to approve officers' compensation than to approve directors'. This Committee believes the new provisions better address the situation where abusive compensation is most likely and are also more suited to the actual operations of many organizations.

For comparison purposes, summaries of the present statute and of the bill follow:

PRESENT LAW

Current N-PCL §715, which parallels the Business Corporation Law in most respects, provides that transactions between a not-for-profit corporation and "interested directors and officers" are not void or voidable if either:

(a) full disclosure was made as to the interest of the director or officer in the transaction and the board, board committee or members authorized the transaction by, in the case of board or committee authorization, a sufficient vote without counting the vote of the interested director or officer; or

(b) the parties to the transaction establish affirmatively that the transaction was fair and reasonable to the corporation at the time it was authorized by the board, board committee or members.

Current N-PLC §715 also provides that the board has authority to fix the compensation of directors for services in any capacity unless otherwise provided in the certificate of incorporation or by-laws. Further, current N-PLC §715 provides that officers' salaries, unless fixed in or pursuant to the by-laws, must be fixed by the affirmative vote of a majority of the entire board or a higher proportion if so provided in the certificate of incorporation or by-laws.

PROPOSED LAW

Proposed N-PLC §715 would replace current N-PLC §715 in its entirety. The proposed legislation contains section (a) through (h), described as follows:

(a) A transaction between a not-for-profit corporation and a director or officer or an entity in which a director or officer is a director or officer or has a substantial financial interest, is void or voidable by the corporation or the Attorney General unless the interested director or officer or any approving director makes an affirmative showing that the transaction was fair and reasonable at the time it was entered into.

(b) A presumption that the transaction was fair and reasonable is created if the following conditions are satisfied:

(i) the transaction was approved in advance by the board or board committee by a sufficient vote not counting the vote of the interested party, and by the members, if any, entitled to vote on the transaction, with knowledge of all material facts by those entitled to vote on the transaction;

(ii) appropriate data as to comparability was obtained and relied upon, and was provided to all individuals entitled to vote on the transaction; and

(iii) the basis for approval of the transaction was adequately documented, which documentation must include the terms of the transaction and the date it was approved, the names of those present when the transaction was discussed and those who voted on it, the comparability data relied upon and a description of how it was obtained, and any actions taken with respect to consideration of the transaction by the interested party.

Subsection (b) also provides that grants between corporations exempt from tax under Internal Revenue Code section 501(c)(3) otherwise falling under this statute must only meet the provisions of subparagraph (i) above to establish presumption of fairness.

(c) The corporation or Attorney General may void or modify the transaction (unless that action would put the corporation in a worse position) in the following circumstances:

(i) the interested director or officer or approving director failed to meet their burdens under paragraph (a) or failed to comply with paragraphs (e) or (f); or

(ii) the interested party or approving directors failed to establish the fairness of the transaction. Proposed N-PLC §715(c) allows the corporation or Attorney General to seek restitution from the interested director or officer or the approving director in amounts equivalent to those available to the Internal Revenue Service under §4958 of the Internal Revenue Code of 1986, as amended ("IRC"), regardless of whether the corporation is subject to IRC §4958 and regardless of whether the Internal Revenue Service pursues its remedies under IRC §4958. Restitution under IRC §4958 requires repayment of consideration in excess of reasonable amounts. IRC §4958 also provides for penalties on the parties, which are not applicable under the bill.

(d) The corporation, through its certificate of incorporation or by-laws, may place additional restrictions on contracts or transactions between a corporation and its directors, officers or other persons and provide that contracts or transactions in violation thereof will be void or voidable.

(e) Compensation to directors or to officers (in capacities other than sitting on the Board), including for services performed on behalf of the corporation as a director or officer of another entity, must be set by the Board or by a Committee of the Board comprised solely of non-compensated directors, or if relevant, by a majority of the members, and such compensation must be fair and reasonable in accordance with the standards of Internal Revenue Code section 4958.

(f) Compensation of directors for serving on the Board or any Committee must be approved by at least a majority of the entire Board, and must be fair and reasonable in accordance with the standards of Internal Revenue Code section 4958.

(g) This subsection sets out definitions of terms used in the bill.

(h) With the exception of compensation of directors or officers, the law is inapplicable to any contract or transaction of which the director or officer has no actual knowledge and which does not exceed the lesser of one percent of the gross receipts of the corporation or one hundred thousand dollars.

Respectfully Submitted,

M. Antoinette Thomas
Chair

MAT:kah

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[*] Mr. Kushner dissented from the Committee's approval of the foregoing comments.
[**] Mr. Siegal abstained from the Committee's vote on the foregoing comments.