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New York Nonprofit Revitalization Act Rollout Challenges

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As the July 1, 2014 compliance date of the New York Nonprofit Revitalization Act of 2013 (the "Revitalization Act") quickly approaches, many charities operating in New York are confronting some difficult rollout challenges. While parts of the Revitalization Act are clear and welcomed (such as new rules that broaden the use of electronic communications and eliminate the need for supermajority board approvals of routine property transactions),[1] other new requirements are puzzling to many of these charities' officers and directors. Indeed, as we counsel our clients, we are finding that certain new Revitalization Act rules that concern board operations are causing some charities, in particular family foundations and corporate foundations, to wonder whether operating through corporations formed in New York is desirable.

The charities that seem to be facing the hardest issues are foundations with small boards, and with directors that either directly and appropriately exert substantial influence over foundation operations (such as in a family foundation), or are employed by the businesses that have founded and fund these charities to do their good works.

We are finding that many, but not all, of the requirements causing concern are tied to vague drafting in the Revitalization Act. The good news is that we have also identified what we believe are reasonable interpretations of the law that align with workable solutions for many clients.

This client alert notes just a few of the more pressing Revitalization Act issues, as well as relevant potential solutions, as they appear to us today. We will be highlighting other aspects of the Revitalization Act rollout over the coming year. We stress that the New York State Attorney General's Charities Bureau may issue clarifying Revitalization Act guidance, and it is also possible that follow-up legislation may address some of these issues. Importantly, it is possible that this guidance or future legislation will not support our interpretations, although we hope that it does. Stay tuned.

Three Independent Directors

The Revitalization Act will require many charities to identify at least three individuals that satisfy detailed requirements of "independence" to serve as directors and oversee specified audit and financial reporting activities. (Three are needed because that is the fewest number of directors required by New York law to perform delegated board-level functions.) For many family foundations, corporate foundations, and labor/management charities – with small boards that are typically composed of individuals tied in some way to the charity or related entities – this requirement has created concern. This concern may be heightened when membership on the board has been finely balanced to achieve acceptable approaches to shared governance.

Most important for these charities to keep in mind is that the requirement is limited to charities that raise or "solicit" funding from the general public. However, some of these charities, in their annual charities filing with the New York Attorney General, may have been filing as soliciting charities even though they do not actually solicit funding. We suggest that such charities consider amending their filing status and we urge that any change in filing status in response to the Revitalization Act be made in consultation with corporate and tax counsel, closely assessing individualized factors and risks. For example, part of the analysis may be to examine whether the charity has been filing its annual Form 990 with the Internal Revenue Service ("IRS") as a "public charity" (based on "public support" concepts of the IRS that differ from the New York concepts of "solicitation"). While we do not believe that the New York charitable solicitation concepts match the IRS concepts, tailored assessments should be made with both New York charitable solicitation laws and U.S. federal tax laws in mind.

For those charities that do solicit within the meaning of New York law, and whose small boards are populated by individuals employed by related entities, it will be worthwhile to take a hard look, again guided by counsel, at the kind of control exerted by a charity's affiliated corporate entities over the charity. Under the Revitalization Act, whether that employment disqualifies a director as "independent" will depend on whether the particular corporate or other entity that employs the director "controls" or is "under common control with" the charity. Notably, the Revitalization Act does not define "control."

Conflicts Policy Quagmire

Although the Revitalization Act is clear that the requirement for independent-director oversight of auditing and financial matters is limited to "soliciting" charities, the law is less clear about whether independent director oversight also applies to the law's requirements on conflicts policies.

Essentially, the Revitalization Act codifies the widespread practice already adopted by many charities – many motivated by the IRS Form 990 conflicts policy checkbox – to have a written conflicts policy. It also requires oversight of adoption, implementation, and compliance with the conflicts policy by the Board or the audit committee. Certain provisions of the Revitalization Act can be read as requiring these oversight functions to be handled by independent directors only. While our interpretation is not free from doubt, we believe that to the extent there is an obligation to have independent directors oversee conflicts policy administration, a close and reasonable reading of the Revitalization Act supports the interpretation that such requirement is also confined to soliciting charities. If not, many private foundations will be forced to make drastic board changes for conflicts policy oversight, while permitted to use directors that do not satisfy independence criteria for what is generally viewed as the critical audit oversight function – a seemingly absurd result.

Charities with conflicts policies based on the IRS form are probably already aware that they will need to amend those policies to satisfy Revitalization Act requirements, since the IRS form does not track all of the components of a conflicts policy required by the Revitalization Act. As these policies are drafted, special attention should be paid to the annual conflicts questionnaire required by the Revitalization Act. Many charities already distribute an IRS Form 990 annual questionnaire to directors, officers and key employees. Revitalization Act questionnaires will now be covering some, but not all, of the same territory. To avoid bombarding individuals with duplicative annual forms, consideration should be given as to whether to use a single questionnaire that reasonably covers both IRS and Revitalization Act requirements.

Approval of Director, Officer, and Key Employee Compensation

The Revitalization Act imposes significant new requirements concerning related-party transactions. Among other things, the Revitalization Act imposes a new requirement to "contemporaneously document in writing the basis for the board or authorized committee's approval" of a related party transaction, "including its consideration of any alternative transactions." The Revitalization Act also provides the Attorney General with enhanced enforcement authority to void, rescind, seek restitution, and remove directors in connection with a transaction that is not properly approved or that was not reasonable or in the best interests of the corporation at the time the transaction was approved.

Because the Revitalization Act broadly defines a "related party transaction" as "any transaction, agreement, or any other arrangement in which a related party [including a director, officer or key employee] of the corporation has a financial interest and in which the corporation or any affiliate of the corporation is a participant," there is some question as to whether compensation arrangements with directors, officers, and key employees are related party transactions. While the matter is not free from doubt, we believe that there is a reasonable basis for considering these compensation arrangements to be regulated in a manner distinct from related party transactions under the Revitalization Act. Clarification on this issue, however, would be helpful.

In addition, the Revitalization Act appears to define all directors as "related parties," and prohibit all related parties from participating in deliberations and voting pertaining to related party transactions, without specifically distinguishing between directors who have an interest in the particular transaction and those who do not. Guidance clarifying that the Revitalization Act will not be construed or enforced in such an impracticable manner would be helpful.

Also, certain ambiguous language in the Revitalization Act can be read as expressly prohibiting any director from being present at or participating in any board deliberations or vote concerning director compensation, while apparently requiring director approval of the compensation. While we believe that such a reading of the Revitalization Act would be unreasonable and contrary to principles of statutory construction, clarifying guidance would help avoid uncertainty on an important governance issue. In the interim, boards may wish to approve director compensation arrangements prior to July 1.

Extraterritorial Application of Revitalization Act

Finally, some commentators have raised concerns that certain provisions of the Revitalization Act relating to board composition and operation may be applicable to charitable organizations formed outside of New York, such as Delaware non-stock corporations. We have not found this to be a reasonable interpretation of the Revitalization Act. Again, however, clarifying guidance would be welcome.

[1] *See* http://nonprofitlaw.proskauer.com/tag/non-profit-revitalization-act-of-2013/ for prior discussion of these provisions of the Revitalization Act.

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