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MEMORANDUM

TO: LeadingAge New York

FROM: Hinman Straub P.C.

RE: Recent Legislative Changes to the Not-for-Profit Corporation Law

DATE: February 10, 2017

The Governor has recently signed legislation making numerous changes to the Not-for-Profit Corporation Law (“NPCL”) impacting various provisions of the Not-for-Profit Revitalization Act. The provisions of the legislation, which is Chapter 466 of the Laws of 2016, will be effective 180 days after November 28, 2016. Although these statutory changes will not be effective immediately, the impact of several of these changes on not-for-profit entities may prompt the entities to make any necessary changes in their Bylaws and also to allow such entities to consider postponing certain actions (such as reviewing related party transactions and determining the independence of directors) until these new provisions become effective.

The statutory changes are generally divisible into two categories, namely, those changes impacting on the Board of Directors itself, and those changes impacting the individual Directors. Below is a summary of the provisions for each of those categories.

A. Provisions Impacting the Board of Directors of Not-for-Profit Corporations:

1. Committees of the Board of Directors. The new legislation amends NPCL §712 to authorize the Board of Directors to create committees of the Board, which must consist of at least three (3) Directors. Previously such authority to create committees of the Board of Directors was required to be authorized by the Certificate of Incorporation or the Bylaws of the not-for-profit corporation. The Board itself must appoint the members of each of these committees, except that with respect to an executive committee the appointment of the committee members must be made by a majority of the entire Board, unless the Board has more than thirty (30) members. The impact of this change in the law is that the appointment of directors to the executive committee would need to be approved by a number of directors which would constitute a majority of the Board assuming that all directors were present and including all vacant directorships (the “entire board”).

All committees established by the Board will have only the authority specifically delegated to that committee by the Board of Directors in the resolution establishing that committee, or the authority delegated to that committee as set forth in the Certificate of Incorporation or Bylaws of the corporation. This new law also now permits directors who hold certain positions in the corporation (chief financial officer, etc.) to be ex officio members of specified committees of the Board of Directors.

Currently NPCL §712 specifies certain powers which the Board of Directors may not delegate to any Board committee (i.e. amendment of the Bylaws). The recent changes to NPCL §712 now specify that the following additional powers may not be delegated by the Board of Directors to any committee and must be exercised only by the Board:

- a. The election or removal of officers and directors.
- b. The approval of a merger or a plan of dissolution.
- c. The adoption of a resolution recommending to the members of the not-for-profit corporation actions regarding the sale, lease, exchange or other disposition of all or substantially all of the assets of the not-for-profit corporation.
- d. The approval of any amendments to the Certificate of Incorporation.

If the Board of Directors of a not-for-profit corporation desires to implement any of these changes with respect to its committees, there will likely be changes required to the Bylaws of the corporation.

2. Delegation of Oversight of Related Party Transactions to a Specified Committee. Currently §715 of the NPCL provides that a not-for-profit corporation may not enter into a “related party transaction” unless that transaction is determined by the Board of Directors to be fair, reasonable and in the corporation’s best interest at the time that the determination is made. The recent changes to the Not-For-Profit Corporation Law now allow the Board of Directors of a not-for-profit corporation to delegate to a specified committee of the Board the ability to make this determination with respect to a related party transaction before the transaction is entered into. If such authority to make this determination is delegated by the Board to a committee, the Board of Directors will not be directly involved in the determination that the related party transaction is proper, but the action by the committee authorizing the related party transaction must be reported to the Board. This change in the law will generally allow the review and determination of related party transactions to be made more quickly since the full Board of Directors will not be involved. Also, it is advisable that the committee to which this power is delegated is composed primarily of independent directors.

In addition, if a legal action is brought by a person or entity, other than the Attorney General, with respect to a potential violation of the related party transaction rules, there is now a statutory defense available to the not-for-profit corporation regarding such potential violations. The new law provides that it is a defense to a claim of a violation of the related party

transaction requirements if the transaction was fair, reasonable and in the best interest of the not-for-profit corporation at the time that the corporation approved the transaction. Therefore, it is important that any related party transaction be properly identified, reviewed and approved by the Board of Directors or the designated committee of the Board, and that the basis for approving the transaction is recorded in writing.

Significantly, if an action is brought by the Attorney General with respect to a possible violation of the related party transaction rules, and if that related party transaction was not approved by the Board of Directors or the designated committee as required under NPCL §715, then the statutory defense to that possible violation brought by the Attorney General is available only if (1) it is determined that the transaction was fair, reasonable and in the best interest of the not-for-profit corporation at the time that the transaction was approved, and (2) prior to receipt of a request by the Attorney General for information regarding the related party transaction the Board has ratified the transaction by finding in good faith that the transaction was fair and reasonable and in the best interest of the corporation at the time it was approved. Furthermore, if the related party had a “substantial financial interest” in the not-for-profit corporation at the time that the transaction was entered into, the Board of Directors must also determine (1) that the not-for-profit corporation considered alternative transactions to the extent available; (2) that the Board of Directors approved the transaction by not less than a majority vote of the directors present, or the committee members present if the review of the related party transaction was delegated to a committee; (3) there must be written documentation as to the nature of the potential violation and the basis of the Board’s or committee’s ratification of the transaction; and (4) that procedures are in place to ensure that the not-for-profit corporation complies with all provisions of Section 715 with respect to related party transactions in the future. In order to have this statutory defense available in an action brought by the Attorney General, the not-for-profit corporation should have all of the actions described in the preceding sentences in place at the time that the related party transaction is approved.

During the consideration of this statutory change, the Attorney General’s Office requested that this defense regarding a related party transaction must have been formalized and documented prior to the Attorney General’s Office seeking information regarding this related party transaction. Therefore, contemporaneous appropriate documentation by the Board or the committee should be prepared in all cases of a review of a related party transaction.

3. An Employee of the Not-for-Profit Corporation Serving as Board Chairperson. NPCL §713(f) currently prohibits an employee of a not-for-profit corporation from serving as the Chairman of the Board of Directors. NPCL §713(f) has now been amended to provide that an employee of the not-for-profit corporation may serve as the Chairman of the Board of Directors provided (1) that two-thirds of the entire Board approves that employee’s election as the Chairman of the Board; and (2) that contemporaneously with that vote the Board documents in writing the basis for its approval of that election. If an employee should be elected as Chairman of the Board of Directors that employee will not be considered to be an independent director for any purpose of the Not-for-Profit Corporation Law. It should be noted that approval by the “entire Board” requires that the number of all current and vacant seats on the Board be included in determining the required affirmative votes.

The Bylaws of many not-for-profit corporations may currently prohibit an employee of the corporation from serving as the Chairman of the Board of Directors. If a not-for-profit corporation desires to permit an employee to serve as the Chairman of the Board of Directors, the Bylaws of that corporation would need to be amended to permit this action and should include a requirement that the rules applicable to the election of that employee as Chairman be included in the Board records.

4. Conflict of Interest Policy. NPCL §715-a requires that all not-for-profit corporations adopt a conflict of interest policy. The new legislation now requires that the Board of Directors be required under NPCL §715-a to not only adopt a conflict of interest policy, but also that the Board must “oversee” the implementation of and compliance with the conflict of interest policy. This change in the Not-for-Profit Corporation Law requires that the not-for-profit corporation adopt procedures for disclosing a conflict of interest or possible conflict of interest to the Board or to a specified committee of the Board, and also that the Board adopt procedures for the Board or such committee to determine whether a conflict actually exists. This change in the law will allow the Board of Directors to delegate to a committee direct oversight of the conflict of interest policies, but the Board must receive regular periodic reports from that committee in order that the Board fulfill its obligation to “oversee” the implementation of and compliance with the conflict of interest policy.

5. Whistleblower Policy. Similar to the conflict of interest policy described above, NPCL §715-b now requires that the Board of Directors of a not-for-profit corporation not only adopt a whistleblower policy, but that the Board must also oversee the implementation of and compliance with the whistleblower policy. Similar to the conflict of interest policy, as described above, the whistleblower policy may be delegated to a specified committee of the Board of Directors, provided that any directors who are employees of the corporation may not participate in the Board or committee deliberations or voting relating to the administration of the whistleblower policy. In addition, these amendments to the Not-for-Profit Corporation Law require that with respect to the whistleblower policy the person who is the subject of the whistleblower complaint may not be present at or participate in the Board or committee deliberations or vote on this matter. However, the Board or the committee handling the whistleblower investigation may request that the person who is the subject of the whistleblower complaint present information as background or answer questions presented by the committee or the Board prior to the commencement of deliberations or voting relating to a possible violation of the whistleblower policy.

B. Provisions Impacting on Directors

1. Definition of an Independent Director. These new amendments to the Not-for-Profit Corporation Law provide more specific requirements with respect to individuals who are able to be classified as independent directors. The Not-For-Profit Corporation Law requires that certain actions must be approved only by independent directors, and therefore it is important to determine who qualifies as an independent director. The first change is that a “key person” (rather than a key employee) will never be considered as an independent director. A key person (whether or not an employee) is someone other than a director or officer who: (1) has responsibilities or who exercises power or influence over the not-for-profit corporation similar to

the responsibilities, powers or influence of officers and directors; (2) is a person who manages a segment of the not-for-profit corporation that represents a substantial portion of the activities, assets, income or expenses of the corporation; or (3) is a person who alone or together with others controls a substantial portion of the capital expenditures or operating budget of the not-for-profit corporation. The intent of these changes is to broaden the class of individuals who may be considered key persons since it is possible in some corporations for a person who is not technically an employee, director or officer to have great influence over the corporation.

The definition of an independent director in NPCL §102(a)(21) specifically provides that anyone who has been a key person within the last three years (or who is a relative of a key person) may not be considered independent. Therefore, it is important to determine who is a key person, since if that key person (or a relative) becomes a director, that person will not be classified as an independent director.

The new provisions of the NPCL also substantially change the types and amounts of payments which may be received from a not-for-profit corporation, or the amounts of payments provided to the not-for-profit corporation, by a director (or the employer of the director) which would disqualify that director from being deemed independent. Previously, the amounts which may be received from or paid to a not-for-profit corporation before a person could not be classified as independent were relatively low which resulted in many directors being classified as not independent. The law now provides that to be classified as an independent director the person must not be an employee or have a substantial financial interest in an entity which has provided payments, property or services, or has received payments, property or services, with respect to the not-for-profit corporation or an affiliate exceeding a certain monetary threshold. For example, if the not-for-profit corporation has revenues of more than \$500,000 but less than \$10,000,000, the amount of payments, property and services which will disqualify a director from being classified as independent is \$25,000 in any of the last three fiscal years. There are other monetary thresholds for not-for-profit corporations with other ranges of gross revenues. The intention of this change is to reduce the number of directors who will not qualify as independent solely based on the amount of payments to or receipts from the not-for-profit corporation.

An additional limitation which currently exists regarding the ability to qualify as an independent director is that the director must not have received more than \$10,000 in compensation from the not-for-profit corporation in any of the last three fiscal years. The new legislation provides that the amount of the compensation received has not changed (it remains \$10,000) but the term "compensation" will no longer include reimbursement for expenses incurred as a director, and will not include reasonable compensation received for services as a director pursuant to NPCL §202(a). Assuming that the compensation for a director of the not-for-profit corporation is reasonable, the exclusion of the amount of the director's fee from the definition of compensation allowable will not result in that director being classified as not independent simply because of the payment of the director's fee. This change is intended to permit existing directors of not-for-profit corporations who receive director's fees to possibly qualify as independent directors.

In addition, the term “payment” when referring to amounts being made by the not-for-profit corporation to an individual, or referring to amounts being made by an individual to the not-for-profit corporation, will not include charitable contributions, or dues or fees paid to the not-for-profit corporation for services which the corporation provides as part of its non-profit purposes, or (as a new exclusion) payments made by the not-for-profit corporation at a fixed or non-negotiable rate or amount for services received by or provided by the not-for-profit corporation, as long as the services provided by the not-for-profit corporation or rendered to the not-for-profit corporation are available to individual members of the public on the same terms, and also that such services received by the not-for-profit corporation are not available from another source. This new category of amounts which will not be included in the definition of a “payment” will exempt from consideration in determining if a director is independent amounts paid for utilities and other services which are provided to the public on a uniform basis. These new exclusions in calculating the amounts of payments paid by or received by the not-for-profit corporation are intended to reduce the instances when a director will not be considered independent. For example, an employee of a utility company who is serving on the not-for-profit corporation’s Board may now be considered independent, whereas previously that director would not be considered as independent because of the amount paid by the not-for-profit corporation for its utilities to the employee of the board member. Also, a person who receives benefits from the corporation in fulfillment of its not-for-profit purposes, may now qualify as an independent director even if the value of those benefits may exceed the applicable monetary limit.

2. Related Party Transactions. Related party transactions require additional review and procedures before receiving approval. The definition of a related party transaction under NPCL §102(a)(24) has been amended to provide additional exclusions for determining if a related party transaction exists. Under the amendments, a related party transaction will not include a transaction where the related party’s financial interest in the transaction is “de minimis” (although there is no threshold amount for what constitutes de minimis). In addition, if the transaction involving the related party (1) would not customarily be reviewed by the board of directors, or by the board of directors of similar organizations, in the ordinary course of business, and (2) the subject of the transaction is available to other people on the same or similar terms, then that event would no longer be considered a related party transaction. This new exclusion should eliminate from review many ordinary transactions which occur with a person who is within the definition of a related party.

3. Finally, if the transaction is intended to constitute a benefit provided to the related party solely because that related party is a member of a class of beneficiaries that the not-for-profit corporation intends to benefit as part of its charitable purposes, and the benefit is available to all similarly situated members of the same class on the same terms, then that activity will not be considered a related party transaction. These changes will exclude many routine transactions which take place between a director and the not-for-profit corporation. The application of this new exclusion as to the existence of a related party transaction must be carefully reviewed by the not-for-profit corporation to make certain that an action for the violation of the related party requirements is not alleged by the Attorney General or another party.

Conclusion

These amendments to the Not-for-Profit Corporation Law are intended to provide additional flexibility with respect to situations which have arisen or for which the Attorney General has received inquiries since the original law was enacted, and also to permit corporations to more effectively adopt appropriate procedures to comply with the legal requirements. As indicated above, some of these changes will require changes to the not-for-profit corporation's Bylaws. Also, since the effective date for many of these changes is not until May, 2017, it may be possible that certain activities which may currently be considered related party transactions may be delayed until the effective date of these changes in order to eliminate the requirements to review and document decisions on related party transactions.

It is anticipated that the Attorney General will be issuing additional guidance closer to the effective date of these changes to the Not-for-Profit Corporation Law. Updated information and guidance will be provided at that time.

If you have specific questions regarding these changes to the Not-For-Profit Corporation Law, please contact us.