

NONPROFIT GOVERNANCE

Pamela A. Mann

CARTER LEDYARD & MILBURN LLP

**Two Wall Street, New York, NY 10005
212-238-8758, mann@clm.com**

PAMELA A. MANN

Pamela A. Mann is the Chair of the Tax Exempt Organizations Practice Group of Carter Ledyard & Milburn LLP. Her practice is concentrated in the representation of tax-exempt organization. She is counsel to numerous public charities and private foundations and advises its clients in a wide range of governance, regulatory, tax, and general corporate matters. Prior to joining Carter Ledyard, Ms. Mann was the Principal in her own firm, specializing in the representation of nonprofit organizations. From 1985 to 1995, Ms. Mann was Chief of the Charities Bureau in the New York Attorney General's office, directing scores of important cases and initiatives and influencing the adoption of significant legislative changes affecting tax exempt organizations. Her diverse background includes clinical teaching at Rutgers University School of Law's Constitutional Litigation Clinic and the litigation of employment discrimination and other employment related matters at the National Employment Law Project.

Ms. Mann has been recognized in New York Magazine's Best Lawyers in New York and in Super-Lawyers Magazine in the category of lawyers specializing in Nonprofit/Charities Law. Ms. Mann was Chair of the Committee on Nonprofit Organizations of the Association of the Bar of the City of New York from 1998-2001 and has served as President and Vice-President of the National Association of State Charities Officials. She is a member of the American Law Institute, the Government Relations Committee of the Nonprofit Coordinating Committee of New York and of the Exempt Organizations Committee of the American Bar Association. She has written many articles for professional and lay publications and is a frequent lecturer on non-profit issues. She is a graduate of Oberlin College and the University of Pittsburgh School of Law.

Attorneys advising nonprofits and their boards of directors must be aware of both the legal norms governing their conduct and the operative public perceptions concerning not-for-profits and their boards. These legal principles are based in both state and federal law, with the requirements of each body of law being generally, but not entirely, consistent. The additional legal pitfalls and operational issues presented in the operation of organizations with voting members corporations are also discussed. This outline will discuss the basic state and federal laws governing the fiduciary responsibilities and potential liability of nonprofit boards and issues related to appropriate governance behavior in each of these contexts.

I. The Legal Duties of Not-for-Profit Officers and Directors: New York State Law

Officers and directors are considered fiduciaries of the not-for-profit organizations they manage. Scheuer Family Foundation, Inc. v. 61 Associates, 179 A.D.2d 65, 582 N.Y.S.2d 662 (1st Dept. 1992); The Martha Graham School and Dance Foundation, Inc., et al v. Martha Graham Center of Contemporary Dance, et al, 224 F. Supp. 2d 567 (S.D.N.Y. 2002), aff'd in part, rev'd in part on other grounds, 380 F. 3d 624 (2d Cir. 2004). Their fiduciary duties, derived from common law, are articulated in the New York Not-for-Profit Corporation Law ("N-PCL").

A. The Duty of Care

Nonprofit directors and officers owe the organization on whose boards they serve a duty of care, articulated in Section 717 of the N-PCL as follows:

Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

1. This formulation of the standard of care is an "expansion of the duty of the comparable section of the Business Corporation Law which does not contain the words 'care' and 'skill.'" Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 186 Misc. 2d 126, 715 N.Y.S.2d 575, 593 (Sup. Ct. N.Y. Cty., 1999).

2. As at least one commentator has observed, this language is too general and nebulous to be a helpful guide to director and officer conduct. See Fishman, "Standards of Conduct for Directors of Nonprofit Corporations," 7 Pace L. Rev. 389, 393 (1987) (hereinafter "Fishman").

3. However, N-PCL § 717 does suggest that the board members must conscientiously decide the matters that come before it, create and enforce "internal information systems" and "serve as a check or veto on management." Fishman at 393.

4. The business judgment rule, applicable to New York not-for-profit corporations, creates a bar to judicial inquiry into actions of corporate directors taken in good faith. Consumers Union of U.S. v. New York, 5 N.Y.3d 327 (2005), following Auerbach v. Bennett, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920, 925 (1979)(business judgment rule applicable to for-profit corporations). See also People v. Grasso, 11 N.Y.3d 64 (2008) (Attorney General cannot

circumvent business judgment rule defense by pleading an action disregarding the knowledge element);

5. On the other hand, where the directors are guilty of “bad faith and self-dealing, or decisions affected by inherent conflicts of interest, judicial inquiry is triggered.” Spitzer ex rel The New Dance Group Studio v. Schussel, et. al., 851 N.Y.S.2d 74 (Sup. Ct. N.Y. Cty 2007) (citations omitted)

6. In suits by third parties, as opposed to suits by the corporation itself, many states have limited liability to instances involving gross negligence or intentional harm. See, e.g., N-PCL § 720-a.

B. The Duty of Loyalty

The duty of loyalty requires a director to pursue the interests and mission of the not-for-profit with undivided allegiance. However, beyond N-PCL § 717(a)’s reference to discharge of directorial duties “in good faith,” there is no statutory formulation of the general duty of loyalty. One must look to case law for an articulation of the standard under New York law.

1. To satisfy the duty of loyalty, a director must act “‘with an eye single to the interests’ of the [organization] to whom he owed a fiduciary duty.” The Martha Graham School and Dance Foundation, supra, quoting Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982) Directors must “subordinate their individual and private interests to their duty to the corporation.” Nechis v. Gramatan, 231 N.Y.S.2d 383, 35 Misc.2d 949 (Sup. Ct. Westchester County 1962), quoting Winter v. Anderson, 242 A.D. 430, 275 N.Y.S. 373 (4th Dept. 1934).

2. They also are prohibited from utilizing their fiduciary position to usurp a business opportunity or advantage available to the corporation. This “corporate opportunity doctrine” has been described as follows:

If there is presented to a corporate officer or director a business opportunity ... in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of [the] corporation, the law will not permit [the officer or director personally] to seize the opportunity....

Robinson v. R & R Publ’g, Inc., 943 F.Supp. 18 (D.D.C. 1996), quoting Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503, 511 (Del. 1939). See also American Baptist Churches of Metro. N.Y. v. Galloway, 271 A.D.2d 92, 710 N.Y.S.2d 12 (1st Dept. 2000); Bolton v. Stillwagon, 410 Pa. 618, 190 A.2d 105 (1963), Fishman at 431-432.

3. One particular type of self-dealing conduct – loans from the not-for-profit to an officer or director – is explicitly prohibited by N-PCL § 716.

4. The duty of loyalty does not bar all transactions between a director and the not-for-profit. Section 715 of the N-PCL allows these “interested party transactions” under certain specified circumstances.

- a. The directors' or officers' interest in the transaction must be fully disclosed to the board or be known by them and the transaction must be authorized by a vote of "disinterested" board members, i.e., a majority of the board that does not include the vote of the interested director. N-PCL § 715(a)(1).
- b. In a membership organization, the transaction may be authorized by a vote of the members, if the material facts of the interest are disclosed to the members or known to them. N-PCL § 715(a)(2).
- c. Interested officers and directors can be present at a meeting at which approval of the transaction in which they have an interest is considered, and they can be counted in determining the presence of a quorum at such meeting. N-PCL § 715(c).
- d. The interested party transaction may still be binding on the corporation even in the absence of the required disclosure and in the absence of a vote of disinterested board members, as where the interested director's vote was necessary for the authorization of the transaction. Under those circumstances, the parties to the transaction must "establish affirmatively that the contract or transaction was fair and reasonable as to the corporation..." N-PCL § 715(b).

C. Duty of Obedience

1. The board has the responsibility to assure that the corporation uses its resources only for the stated purpose and mission of the organization. See Manhattan Eye, Ear & Throat Hospital v. Spitzer, 186 Misc. 2d. 126, 152 (NY Sup. Ct. 1999) ("It is axiomatic that the Board of Directors is charged with the duty to ensure that the mission of the charitable corporation is carried out. This duty has been referred to as the 'duty of obedience.'")

2. Not all authorities recognize the duty of obedience as a separate legal duty, however. Comment g(3) to § 300 of Tentative Draft No. 1 of the ALI Principles of the Law of Nonprofit Organizations notes that the Principles "do not employ the terminology of a duty of obedience." The Comment acknowledges, however, that directors have the duty to assure that the organization's assets are used for its stated purposes and that the organization complies with the applicable law.

II. Internal Revenue Code Rules Relating to Conduct of Fiduciaries

The Internal Revenue Code ("IRC") also prohibits acts of self-inurement and self-dealing for tax-exempt organizations. IRC § 501(c)(3) requires that every 501(c)(3) organization be operated exclusively for tax-exempt purposes and that "no part of [its] net earnings ... inures to the benefit of any private shareholder or individual ..." While this prohibition affects individuals other than directors and officers, in practice, these rules have the most direct bearing on those charged with the governance of not-for-profit organizations.

A. Rules for Public Charities

IRC § 4958 proscribes “excess benefit transactions” between certain charitable organizations and “disqualified persons” (generally, those in a position to exercise “substantial influence” over the organization). This section gives the Internal Revenue Service the authority to impose penalty taxes (known as “intermediate sanctions,” in contrast to the ultimate sanction, revocation of exempt status) when a transaction is found to bestow an excess benefit on a disqualified person.

1. **Definition of Excess Benefit.** An excess benefit transaction is one in which the economic benefit provided to the disqualified person is greater than the return benefit to the applicable tax-exempt organization. IRC § 4958(c)(1)(A). In short, the deal is lopsided in favor of the disqualified person. Such transactions include unreasonable compensation paid to a disqualified person, including reimbursement for expenses, and sales of property to disqualified persons for less than the fair market value of such property. See P.L.R. 200829049 (Apr. 10, 2008) (payment of personal expenses for meals, car payments, clothing and services in the home of a disqualified person constituted excess benefit transactions and contributed to revocation of exemption); P.L.R. 200247055 (Nov. 22, 2002) (no excess benefit found where benefit to physicians who were disqualified persons from hospital’s free bus service does not exceed benefits to public generally); P.L.R. 200421010 (Feb. 20, 2004) (sharing of expenses for employees, office space, and equipment not an excess benefit transaction where based on detailed allocation records as to the various expenses); P.L.R. 200335037 (June 2, 2003) (nonprofits’ grants which raise a bank’s rating under the Community Reinvestment Act of 1977 did not confer an economic benefit on the bank and thus did not constitute excess benefit transactions).

- a. The excess benefit rules will not apply to fixed payments made during the term and pursuant to a written, binding contract entered into before the newly-hired disqualified person begins work. Thus, for example, the initial contract of an organization’s CEO will not be subject to the excess benefit transaction rules. This is sometimes referred to as the “first bite” exception. However, if the initial contract is modified, renewed, extended, or terminable or subject to cancellation by the organization without penalty, it is treated as a new contract as of the earliest date that such change would be effective. Treas. Reg. § 53.4958-4(a)(3).
- b. Both direct and indirect economic benefits, e.g, benefits provided to a disqualified person through a controlled entity or an intermediary, may be considered excess benefit transactions. Treas. Reg. § 53.4958-4(a)(2).
- c. If a supporting organization makes a grant, loan, payment of compensation or similar payment to a substantial contributor, or a related person, of the supporting organization, the entirety of the prohibited payment is subject to the excise tax. Public charities, other than another supporting organization, are excluded from the definition of disqualified person for this purpose.

2. General Definition of Disqualified Person. A “disqualified person” is one who, at any time during a five-year “lookback” period prior to the transaction, was in a position to exercise substantial influence over the organization. Voting members of the governing body, presidents, chief executive officers, chief operating officers, and chief financial officers are presumed to have substantial influence. Treas. Reg. § 53.4958-3.

- a. In addition, the following family members of those in positions of substantial influence are also considered to be disqualified persons: spouse, ancestors, children, grandchildren, great-grandchildren, spouses of children, grandchildren and great-grandchildren, brothers and sisters and their spouses. IRC § 4958(f)(4). (Note that for private foundations, the list of family members deemed to be disqualified persons by virtue of their relationship excludes the siblings, and their spouses, of the disqualified person.)
- b. Entities as well as individuals can be disqualified persons. An entity where 35% of the control is held by one or more disqualified persons is itself a disqualified person. Treas. Reg. § 53.4958-3(a)(2).
- c. The determination of whether a person (including an entity) is in a position to exercise substantial influence over the organization is measured by the person’s actual powers and duties and not by title alone. The IRS evaluates all the relevant facts and circumstances in determining whether an individual has substantial power or influence. Treas. Reg. § 53.4958-3(e).
- d. Non-profit organizations exempt under IRC § 501(c)(3) are deemed not to be disqualified persons, and organizations exempt under IRC § 501(c)(4) are deemed not to be disqualified persons with respect to other IRC § 501(c)(4) organizations. Treas. Reg. § 53.4958-3(d).

3. Excise Taxes. The penalty for engaging in an excess benefit transaction is a tax on the disqualified person, not on the organization.

- a. The initial tax is equal to 25% of the excess benefit. If the excess benefit is not corrected within a reasonable time, an additional tax equal to 200% of the excess benefit will also be imposed. IRC § 4958(a)(1), (b).
- b. Organization managers may also be subject to penalty taxes in cases where a tax is imposed on a disqualified person and the manager(s) knowingly participated in the transaction, and such participation was willful and not due to reasonable cause (such as reliance upon a written opinion of counsel). IRC § 4958(a)(2). The tax on organization managers is 10% of the excess benefit, up to a maximum total of \$20,000 per transaction. IRC § 4958(d)(2).

4. Safe Harbor Procedures. The regulations contain a set of procedures that, if followed when approving a transaction between a disqualified person and the organization, will

afford the disqualified person the benefit of a rebuttable presumption that the transaction was reasonable. If the transaction is a compensation arrangement, a rebuttable presumption will be created that the compensation is reasonable, and if the transaction is a transfer of property, a rebuttable presumption will be created that the transfer is at fair market value. This presumption shifts the burden of proving that the transaction was unreasonable (and thus subject to intermediate sanctions) to the IRS. Treas. Reg. § 53.4958-6. It is highly recommended that all non-profit organizations take advantage of the protection the safe harbor provisions offer. The procedures are as follows:

- a. The decision about the transaction must be made in advance by the board (or an authorized committee thereof), composed entirely of individuals who do not have a conflict of interest with respect to the transaction and, thus, are truly “disinterested.” Treas. Reg. § 53.4958-6(a)(1).
- b. The Board or committee must have obtained and relied upon appropriate comparability data in making its decision. Appropriate data as to comparability may include appraisals, other offers or, in the case of compensation decisions, this data can include documented compensation levels of persons working in similar positions in similar organizations. (Similarities of size and geographic location are among the factors considered.) The Board can also look to reliable surveys of compensation levels and expert studies. Treas. Reg. § 53.4958-6(a)(2). See P.L.R. 200244028 (June 21, 2002) (no rebuttable presumption created where minutes of meeting approving compensation failed to substantiate board reliance on compensation study and where compensation study was done after meeting). Organizations with less than \$1 million a year in gross receipts need only rely on comparability data from three other organizations. Treas. Reg. § 53.4958-6(c)(2).
- c. The disqualified persons, or those for whom the transaction presents a conflict of interest, may meet with other members to answer questions, but may not be present during debate and voting on the transaction. Treas. Reg. § 53.4958-6(c)(1)(ii).
- d. The board or committee must document the basis for its decision within 60 days of the action taken, or before their next meeting. The documentation must include: a) the terms of the transaction and the date approved; b) the members of the board, or committee, who participated in the discussion and who voted on it; c) the comparability data relied upon and how it was compiled; and 4) the actions of any member of the board or committee having a conflict of interest with respect to the transaction. Treas. Reg. § 53.4958-6(a)(3), (c)(3).

5. Consistent with an intensified interest in board management of conflicts of interest, the Form 1023 requests information about compensation to directors, officers, trustees, as well as compensated employees and independent contractors. In addition, the Form 1023 asks

for a description of the organization's conflicts of interest policies and whether transactions with officers, employees and contractors are negotiated at arm's length.

6. Similarly, the Form 990 contains many questions about an organization's governance. It requires details regarding an organization's governing body and management, governance policies, and disclosure practices, including the maintenance of a conflict of interest policy, reinforcing the notion that such policies and procedures are, while not required, virtually so. See the IRS website at <http://www.irs.gov/charities/index.html> for more information.

B. Rules for Private Foundations

Organizations which are classified as private foundations by the Internal Revenue Service (generally, organizations which derive their support from one or more related individuals) are subject to special, stringent rules concerning transactions between them and the disqualified persons. With limited exceptions, these rules prohibit these so-called "self-dealing" transactions between disqualified persons and the private foundation, regardless of the benefit (or lack thereof) to either party, and impose excise taxes for violations of these rules. IRC § 4941.

1. **Definition of Disqualified Person.** Although the term "disqualified person" is also used in connection with excess benefit transactions, it is defined somewhat differently in the private foundation context.

- a. For purposes of the self-dealing rules, disqualified persons are defined as follows: a) substantial contributors to the foundation (typically the founder and other major donors); b) foundation managers (typically directors and officers); c) an owner of more than 20% of the voting power, profits interest or beneficial interest of a corporation, partnership or trust, respectively, that is a substantial contributor to the foundation; d) the spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of children, grandchildren and great-grandchildren of a person described in a), b) or c), above; and e) entities in which disqualified persons own more than 35% of the equity, voting power, or beneficial interests. IRC § 4946(a).
- b. Note that the siblings (and their spouses) of disqualified persons are not considered disqualified persons in the self-dealing context, whereas they are for purposes of the excess benefit transaction rules.
- c. Only those individuals or entities meeting the technical definition are considered disqualified persons, in contrast to the excess benefit transaction context, where any individual or entity that is in a position to exercise substantial influence will be considered a disqualified person.

2. **Definition of Self-Dealing Transaction.** The following transactions (whether direct or indirect) between a private foundation and a disqualified person are acts of self-dealing and are strictly prohibited, with certain limited exceptions. IRC § 4941(d)(1).

- a. The sale, exchange or leasing of property between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(a), (b).
- b. A loan or other extension of credit between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(c).
- c. The furnishing of goods, services or facilities between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(d).
- d. The payment of compensation, including reimbursement of expenses, by a private foundation to a disqualified person. Treas. Reg. § 53.4941(d)-2(e).
- e. The transfer of a private foundation's income or assets to or for the benefit of a disqualified person, including the use of such assets by the disqualified person. Treas. Reg. § 53.4941(d)-2(f).
- f. The agreement by a private foundation to make payments of money or other assets to a government official. Treas. Reg. § 53.4941(d)-2(g).

3. Exceptions to the Self-Dealing Rules: Although the rules cited above are per se prohibitions, the exceptions limit their negative impact to some extent, as they encompass some of the most benign transactions between disqualified persons and the private foundation:

- a. The leasing of property by a disqualified person to a private foundation without charge does not constitute self-dealing, even when the private foundation pays for the basic maintenance costs it incurs in relation to its use of the property (as long as the payment is not made directly or indirectly to the disqualified person). Treas. Reg. § 53.4941(d)-2(b)(2).
- b. The lending of money, or extension of credit, to a private foundation by a disqualified person is not an act of self-dealing as long as no interest or other charge is involved. Treas. Reg. § 53.4941(d)-2(c)(2).
- c. It is not an act of self-dealing for a disqualified person to furnish goods, services or facilities to a private foundation without charge. For purposes of this exception, the private foundation can pay for transportation, insurance and maintenance costs associated with its use of the property or services, as long as the payment is not made directly or indirectly to the disqualified person. Treas. Reg. § 53.4941(d)-2(d)(3).
- d. It is not an act of self-dealing for a private foundation to furnish goods, services or facilities to a disqualified person so long as they are made available to the general public on as least as favorable terms. Treas. Reg. § 53.4941(d)-3(b)(1).
- e. It is not an act of self-dealing for a private foundation to pay compensation to a disqualified person for personal services rendered that are reasonable and necessary to carry out the exempt purposes of the foundation, as long

as the compensation is not excessive. This exception does not apply to government officials. Treas. Reg. §§ 53.4941(d)-2(e), 53.4941(d)-3(c)(1).

- f. A disqualified person can receive incidental benefits from a private foundation's use of its income or assets without running afoul of the self-dealing rules. For example, if a private foundation gives public recognition to a disqualified person who has been a substantial contributor to the foundation, this benefit is viewed as incidental and, thus, is not an act of self-dealing. Treas. Reg. § 53.4941(d)-2(f)(2).
- g. The "First-Bite" Exception. Self-dealing does not include a transaction between a private foundation and a disqualified person where the disqualified person status arises as a result of the transaction. For example, if a person sells property to a foundation at a bargain price and, as a result of this transaction becomes a substantial contributor (and, thus, a disqualified person) as a result of the transaction, this "first-bite" transaction will not be considered an act of self-dealing. Treas. Reg. § 53.4941(d)-1(a). However, the person who became a substantial contributor by virtue of this transaction will be treated as a disqualified person going forward.
- h. Transactions During Estate Administration. Fair market value sales and exchanges that occur as part of the administration of an estate of which the private foundation is a beneficiary are not acts of self-dealing but are subject to court approval. Treas. Reg. § 53.4941(d)-1(b)(3).

4. Excise Taxes. The penalty for engaging in a self-dealing is a tax on the self-dealer and foundation managers, not on the organization.

- a. Tax on the Self-Dealer. An initial tax equal to 10% of the amount involved in the act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only in that capacity) who participated in the act. Except in the case of government officials, the tax will be imposed even when the disqualified person had no knowledge at the time of that act that it constituted self-dealing. IRC § 4941(a)(1). A disqualified person is considered to have "participated" in an act of self-dealing even in instances where he directed another person to engage in the transaction. Treas. Reg. § 53.4941(a)-1(a)(3). If the act of self-dealing is not "corrected" (generally, undoing the transaction or returning the private foundation to at least the financial position it would have been in absent the transaction) in a timely fashion, an additional tax of 200% of the amount involved is imposed upon the disqualified person. IRC § 4941(b)(1).
- b. Tax on Foundation Managers. An initial tax equal to 5% of the amount involved in the act of self-dealing is imposed on foundation managers who participate in an act of self-dealing. Participation in this case means that

the foundation manager knows that the transaction is an act of self-dealing, his participation is willful and is not due to reasonable cause (such as exercising ordinary business prudence or relying on a written opinion of counsel). IRC § 4941(a)(2). If the foundation managers refuse to agree to all or part of the correction, an additional tax equal to 50% of the amount involved will be imposed. IRC § 4941(b)(2). Section 4941 taxes on managers are capped at \$20,000 per transaction, regardless of how many foundation managers participated. IRC § 4941(c)(2).

III. Governance Principles for Membership Organizations

A. Definitions and Misconceptions.

A “membership organization,” for governance purposes, is a nonprofit organizations that has members, at least some of whom have voting rights. Under the N-PCL, a “member” is defined as “one having membership rights in a corporation in accordance with the provisions of its certificate of incorporation or bylaws.” N-PCL § 102(a)(9). Organizations classified as Type B organizations (charitable nonprofits) may, but need not, have members with voting rights, while all other nonprofit organizations (Types A, C, and D organizations) must have members with voting rights. If an organization’s governing documents (either its Certificate of Incorporation or Bylaws) explicitly provide for members with voting rights, the nonprofit is a membership corporation.

1. A “member” for governance purposes must be distinguished from the label some organizations use to describe their donors or participants in their programs. There is no limitation on an organization’s ability to create categories of membership. Indeed, there may be advantages to doing so. However, creating these designations gives these “members” no governance rights, absent reference to such rights in the organization’s governing documents.

2. Many charitable nonprofits that were formed under the precursor to the N-PCL, the Membership Corporation Law, provide governance rights for members in their bylaws and believe that they are legally required to retain this structure. In fact, the Membership Corporation Law did not require charitable nonprofits to have members, and, when the N– PCL supplanted the Membership Corporation Law in 1970, charitable nonprofits were henceforth generally considered Type B organizations. N-PCL §113.

B. Scope of Membership Rights.

Members of a New York not-for-profit corporation have ultimate authority over the most important decisions made by the corporation, as well as an ongoing voice in the governance of the organization.

1. The governance rights of members include the power to: a) adopt, amend or repeal bylaws; b) restrict the rights of the board of directors to amend bylaws (N-PCL § 602(b),(c)); c) elect and remove directors (N-PCL §§ 703-06); d) change the size of the board (N-PCL § 702(b); e) call special meetings for the election of directors (N-PCL § 603(c)).

2. Significant corporate events that must be approved by the members include: a) authorizing the amendment of the certificate of incorporation (N-PCL § 802); b) approval of fundamental changes in the structure of the organization such as mergers and dissolutions (N-PCL §§ 510, 906, 908, 1002); c) approval of sale of all or substantially all of an organization's assets (N-PCL §§ 510, 511).

3. Members also have the right to receive or review certain corporate records or information, Specifically: 1) corporate books and records; 2) lists of directors and officers (§ 621, 718); 3) an annual report concerning various financial data as well as the number of members and change in membership (§ 513(b)) ; 4) a list of members of record and minutes of membership meetings (§621(b)); and 5) information related to indemnification and insurance provided to directors and officers (§§ 725(c)(1), 726(d)). See generally, Bjorklund, Fishman & Kurtz, New York Nonprofit Law and Practice, Section 9-1, pp. 298-299 (1997).

C. Governance Implications of Membership Structure

1. Does the board of directors owe a duty to the members of a nonprofit organization and, if so, what is that duty?

- a. The board of directors of a nonprofit with a membership structure must take care to afford the members of the organization all of the rights outlined in the N-PCL and in the organization's bylaws. The board must take particular care, in the drafting of its bylaws and the conducting of its operations, to comply with the various provisions outlined above.
- b. Where members seek to avail themselves of the right to communicate with other members in the context of disputed elections, the directors must facilitate those communications, consistent with the directors' "fiduciary duty to ... the association's membership to conduct the [corporation's] affairs in a good faith effort to promote the best interests of the association." Fitzgerald v. The National Rifle Association of America, 383 F. Supp. 162 (D. N. J. 1974)
- c. In the context of a charitable nonprofit, the members are not allowed to have ownership rights in the organization. While the directors' duty of care requires that they afford the members all of the governance rights guaranteed by the N-PCL and the organization's bylaws, the directors' substantive duties are to the organization itself, not to its members. In certain factual situations, specifically where the members desire an outcome that the board of directors believes is not in the organization's best interests, the directors may find their various obligations to be in conflict.

2. What are the consequences of failing to comply with these provisions?

- a. Members have standing to sue where the organization to which they belong violates their rights, either as generally set out in the N-PCL or the

organization's bylaws or with respect to some of the particular monitoring rights set out above.

- b. For example, Section 621(d) provides a summary procedure whereby a member denied the right to review membership lists or records of membership proceedings may enforce those rights. See also N-PCL § 718(b) (right to apply ex parte for an order requiring organization to produce list of directors and officers).
- c. In addition, members who are harmed by actions taken an organization in a manner inconsistent with the N-PCL may bring action to enjoin those actions.

For instance, in a suit brought by a member of a non-profit, the Appellate Division upheld a Supreme Court ruling nullifying an amendment to the bylaws of a membership organization that would have resulted in the removal of the plaintiff from her position as a director of the organization. The Appellate Division determined that the amendment had been passed in the absence of a lawful quorum, since the quorum requirement in the organization's bylaws had been inconsistent with the N-PCL and, thus, a quorum equal to a majority of the organization's members was necessary to amend bylaws pursuant to section 608(a) of the N-PCL. Sealey v. American Society of Hypertension, 26 A.D.3d 254 (1st Dept. 2006); see also Fitzgerald v. The National Rifle Association of America, supra (suit by dissidents running for office to require placement of their advertisements in organization's publication).

IV. The Impact of the Sarbanes-Oxley Act on Nonprofit Governance

1. In the summer of 2002, the law commonly known as the Sarbanes-Oxley Act or SOX was enacted in response to a rash of corporate accounting scandals and financial abuses. P.L. 107-204 (July 30, 2002). It imposed new requirements on publicly owned companies, and their officers, directors and advisors. Many of Sarbanes-Oxley's requirements are designed to ensure that a company's directors receive an accurate description of the company's financial state and that the financial information about a company that is made publicly available to stockholders and potential stockholders is accurate. Only two provisions of the Sarbanes-Oxley Act apply to not-for-profit corporations:

- a. It is a criminal offense to punish whistleblowers who report to law enforcement officials truthful information about the possible commission of a federal offense. Sarbanes-Oxley Act § 1107.
- b. It is a criminal offense to alter, destroy, or conceal a document, record, or other object with the intent to impair its integrity or availability for use in an official proceeding, or otherwise to obstruct, influence or impede an official proceeding. Sarbanes-Oxley Act §§ 802(a), 1102.

2. Analogous State Legislation. In addition, there have been proposals at the federal and state levels to impose on nonprofits requirements similar to Sarbanes-Oxley provisions that currently apply only to publically traded for-profit corporations.

- a. California. The California Nonprofit Integrity Act of 2004 requires all organizations with over \$2 million in revenue to have an audit, which must be made available to the public, and an audit committee that cannot include staff and must not overlap more than 50% with the finance committee.

The other provisions of the Act have no obvious connection to the mandates of SOX. The Act requires that all nonprofits regardless of size must make their audited financial statements available to the public, following the federal mandate for disclosure of Forms 990; have the compensation of President, CEO, Treasurer and CFO approved by the board; and comply with various registration and reporting requirements triggered by the acquisition of assets or the solicitation of funds in California. (The California authorities have stated that the law applies to nonprofits that solicit funds in California person, even if the solicitation is done via the Internet and the organization is not chartered in or doing business in California; however, this interpretation seems untenable from a constitutional standpoint.)

- b. Proposals in Other States. Other state legislatures have also considered legislation that would apply some of the concepts of Sarbanes-Oxley to nonprofit organizations, but the notion has been the subject of more debate than action. See Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. Davis L. Rev. 205 (2004); Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 Utah L. Rev. 1303 (2003).

3. Best Practices post-Sarbanes-Oxley. Although only the two provisions of the Sarbanes-Oxley Act discussed in A. above are imposed on not-for-profit corporations, it appears that an increasing number of nonprofits are voluntarily adopting policies similar to other Sarbanes-Oxley provisions. Perhaps this is a result, in part, of nonprofit directors' exposure to Sarbanes-Oxley requirements through their service on for-profit boards. The concepts and requirements of Sarbanes-Oxley help ensure financial stability, good governance, and public trust. Sarbanes-Oxley concepts may become the "standard" for determining what constitutes the diligence, care and skill a reasonable person would exercise in carrying out his or her duties as a nonprofit director or officer. Some Sarbanes Oxley "best practices" that are becoming increasingly common among nonprofits are:

- a. Audit Committee. Many organizations have formed audit committees to engage auditors for the organization and to supervise the audit. To function as intended, the audit committee should have at least one member with accounting expertise and should be composed entirely of directors who are not employees of, or otherwise compensated by, the organization, though these goals are not possible for many small organizations or small boards. Term limits for committee members are also advisable. (Note: New York law requires that committees consist of at least three directors).

- b. **Audit Process.** In the aftermath of Sarbanes-Oxley, an increasing amount of attention and care is generally lavished on the audit process and related financial record keeping. The general rules that apply to this important function include:

- 1) **Independence.** The outside auditor should not be related – functionally, organizationally, or otherwise to the firm or individuals that are responsible for the financial record keeping of the organization, and the auditor must be independent of management. The audit firm should not provide other financial services to the organization (e.g., investment advice, bookkeeping, appraisal services, etc.); however, it may make sense to use the same accountant(s) for the audit and for tax preparation

- 2) **Process.** If the organization has an audit committee, it is that body, not the organization or the board, that engages the auditor, communicates with the auditor concerning the audit, determines the auditor’s compensation, and receives or acts upon the audit. The audit committee should meet with the auditors at least once during the course of the audit without the presence of any management representatives and without the chief financial officer.

- c. **Whistleblower Policies.** Many organizations have passed such policies that go well beyond the whistleblower provisions cited above. The Form 990 asks organizations to state whether they have a whistleblower policy.
- d. **Conflict of Interest Policies.** The Internal Revenue Service has virtually mandated the adoption of such policies, requesting information about them on the Form 1023 and the yearly 990s filed by all exempt organizations. In any event, most not-for-profits have moved toward implementing such policies.
- e. **Code of Ethics.** Many organizations have also adopted a code of ethics governing employees and staff, as well as directors and officers.

V. Conclusion

In the current climate of increased public concern over not-for-profit “accountability” and increased regulation by the Internal Revenue Service in the excess benefit transaction arena, it is extremely important that practitioners advising not-for-profit boards provide concrete suggestions for implementing the fiduciary duties of care and loyalty. The differing rules governing various types of nonprofit corporations, as well as the inconsistencies in federal and state standards, create pitfalls for the unwary director at every turn. As is so dramatically illustrated by the nonprofit scandals-du-jour appearing regularly in the press, volunteer boards ignore these rules, and their obligation to abide by them, at their peril.