Revitalization, or at least a package bearing that label, has come to New York nonprofits.

It arrived in the form of a new statute—the Non-Profit Revitalization Act of 2013—that is almost certainly the most complex and prescriptive set of nonprofit governance rules in the United States. As we will describe in detail in this article, the Act’s highly specific codification of governance “best practices” has resulted in:

- A required conflict of interest policy for all nonprofits (including wholly charitable trusts).
- Mandatory procedures (and the risk of stiff financial penalties) for transactions or arrangements between charities and their “related parties.”
- A required whistleblower policy for organizations with 20 or more employees and annual revenue of more than $1,000,000.
- Mandatory audit oversight responsibilities for some fundraising charities and a requirement that “independent” board members or trustees perform the statutory audit function.

This issue is the third and final in a series about the trend toward increasing the governance requirements on nonprofits; it focuses on nonprofit governance at the state level. Although New York is the main destination, we also visit California, Florida, and Massachusetts on this journey. The preceding article considered how the IRS has ventured into the governance arena.
After the Act was signed in December 2013, the Office of the New York Attorney General hailed the new law for setting a high and appropriate standard for nonprofit governance. The Office of the Attorney General wrote: “The public’s trust in the nonprofit sector has... been tested, as stories of public officials and others abusing charities have emerged.” The statement added that the law “will make New York competitive with other states in continuing to attract and nurture the most vibrant nonprofits in the world, and it will make New York a model for nonprofit governance and oversight.”

However, even before the law went into effect on July 1, organizations realized its laudable aims presented operational challenges: how to interpret a sprawling set of provisions sometimes lacking in clarity and how an organization with adequate, even exemplary, governance practices could conform to the “one-size-fits-all” approach of the statute. For the many well-governed organizations, the Act presented hardly any genuinely substantive changes to their governance, but quite a few relatively marginal ones necessary to “get compliant.”

The Act also presented new and not insubstantial burdens for ongoing compliance. Organizations already trying to track the relationships that may create federal excise taxes or public disclosure obligations found themselves with a new responsibility: applying state-law definitions that resemble, but are not quite congruent with, their federal analogs. Example: A “related party” under state law is not the same thing as a “disqualified person” for federal tax purposes or the three different types of “interested persons” for purposes of reporting on IRS Form 990, Schedule J. And an organization’s own fiduciary decisions about how to define conflicts of interest for its governance purposes might yield still another set of conflicts definitions, tailored to the unique needs of the organization and not congruent with any state or federal definition.

Further, an “independent” director or trustee for purposes of the Act’s audit oversight provisions is not the same as an “independent” voting member of the governing body for purposes of the disclosures required on IRS Form 990.

These definitional mismatches seem, at least to some, to have created a kind of Rubik’s Cube of compliance—and a potentially overwhelming (or at least disagreeable) burden for board members and other volunteers asked to fill out increasingly complex questionnaires about themselves and their various family and business relationships. If New York-style nonprofit governance reform takes hold all over the country, in the years ahead, charities operating in multiple states may see this definitional complexity expand and the compliance burden increase.

Promised guidance from the New York Attorney General may provide useful clarity about the Act’s more opaque provisions, but this guidance also has the potential to raise more questions than it answers, or to put forward “clarifications” that represent, in fact, a still-greater set of compliance burdens. One hopes the Attorney General will be mindful of the need for flexibility and patience.

Whether the new law leads to an improvement in nonprofit governance remains to be seen, and to some degree, the answer will never be known. Similarly, the effect of the new rules on volunteers’ willingness to take on governance responsibilities is not quantifiable. What is clear is that other states, and nonprofit pundits and critics, will look to the New York example to see what they can learn—both what to emulate and what to avoid.

California Leads the Way

As a substantive matter, there was comparatively little variation among state laws concerning nonprofit governance until 2004, when California enacted the Nonprofit Integrity Act. Although that law contained a number of provisions related to charitable fundraising, its governance provisions focused mainly on the audit function of only the largest nonprofits. And California’s ambition was modest, at least by comparison to the approach New York would adopt nearly a decade later.

Details of California Nonprofit Integrity Act—Key Governance Requirements are listed in the online edition of this article: bit.ly/npgovernance.
New York Takes Its Time

Even before California enacted its Integrity Act, then-New York Attorney General Eliot Spitzer had crafted a nonprofit governance proposal patterned on the federal Sarbanes-Oxley statute, which is mainly applicable to publicly traded companies. As with California, the focus was on the audit function. Spitzer’s 2003 proposal would have applied only to relatively large organizations and, in those cases, would have required CEO certification of financial reports and the adequacy of internal financial controls, a demonstration of the independence of the audit committee, and an audit committee made up only of board members. The use of executive committees would have been barred for all but the largest boards (those with more than 25 members).

The Spitzer initiative went nowhere. Spitzer’s successor as Attorney General, Andrew Cuomo, continued to focus on the issue of nonprofit governance and succeeded in 2010 in grafting at least two governance rules onto New York’s highly tailored version of the Uniform Prudent Management of Institutional Funds Act, enacted in 2010: (1) that organizations have a written investment policy and (2) that boards document the prudence analysis accompanying decisions to draw funds—even to appropriate the annual draw—from endowment.

The current Attorney General, Eric Schneiderman, took office on January 1, 2011 and almost immediately appointed a Leadership Committee for Non-Profit Revitalization, whose membership included heads of nonprofit organizations and a handful of legal practitioners. Staff of the Attorney General Charities Bureau worked with the Committee, which produced a lengthy report (the “Report”) issued by the Attorney General in February 2012.

The Report offered a number of proposals for “Non-Profit Revitalization,” such as fixing the system for processing contracts between nonprofits and the state and providing cash-flow loans to nonprofits experiencing delays in the contract process. There were pages on this topic, which obviously had nothing to do with nonprofit governance and, in the end, played no part in the Act.

A further section of the Report was entitled “Creating a More Hospitable Environment for Non-Profits.” The Report’s authors wrote that existing laws often produced “unnecessary obstacles for newly forming organizations and frustrating burdens for non-profits already doing business.” Some proposals in this part of the Report, though sometimes modified along the way, did find their way into the Act, and the Act added new simplification measures, too.

Read more about Simplification and Modernization under the Act in the online version here: bit.ly/npgovernance.

California Nonprofit Integrity Act—Examples of Governance Requirements

- Charitable corporations that are required to register and file reports with the California Attorney General and have $2 million or more in gross revenue are required to establish and maintain an audit committee. This means organizations formed outside California but raising money in that state may be subject to the California audit requirements.

- In organizations to which the California law is applicable, the audit committee may not include certain individuals (employees, the CEO, and the CFO), and members of the finance committee may not make up 50 percent or more of audit committee membership. Non-board members may serve on the audit committee of an organization subject to the California law.

The Report’s third major section addressed “Enhancing Governance and Maintaining the Public Trust.” The committee wrote that meaningful improvement of governance “requires a mix of enhancing laws, instituting voluntary best practices, and attracting and bolstering human capital.” First, the report said, “New York needed to strengthen its state law to provide boards with a better roadmap for governance and accountability.” Second, it “needed to spread voluntary best practices.” And finally, the Report concluded that nonprofits “require committed board members with diverse backgrounds and skills, and robust knowledge of their responsibilities.”
Again, many proposals in the Report found their way into the Act; other elements appear to have been products of the Attorney General and legislative process that led to the crafting of the Act. For example:

- The Act follows the Report in prohibiting an employee from serving as board chair or holding any title with similar responsibilities (effective date deferred until January 1, 2016), but
- The Act goes beyond the Report by providing, cryptically, that “committees of the corporation” (i.e., committees that include non-directors) may not “have the authority to bind the board.”

Few of the new governance provisions are as simple as those and do not lend themselves to a few bullet points. They fall into four categories:

- Mandatory conflict of interest policy
- Tighter regulation of related party transactions
- Mandatory audit oversight function
- Mandatory whistleblower policy

Note that each category has different thresholds of applicability. For example, the mandatory conflict of interest policy is applicable to all New York not-for-profit corporations (even trade associations and social clubs) and wholly charitable trusts. The mandatory audit oversight function, however, is limited to certain fundraising organizations. Additionally, non-New York charities that conduct solicitations in New York and have revenue over certain thresholds may be subject to some provisions of the Act, depending on how it is interpreted.

Details of these provisions can be found in the online edition of this article: bit.ly/hpgovernance.

The Future in New York

One key aspect of the Report awaits legislative action: the recommendation to enhance board oversight of executive compensation. Based on the two bills that died in the Legislature and the Attorney General’s focus on this issue, it seems reasonable to predict that an executive compensation bill will eventually emerge and that it will aim to:

- Specify compensation oversight duties, including review of the total compensation of the CEO and other top employees, an affirmative determination that the compensation is fair, reasonable, and commensurate with the services provided, and contemporaneous documentation.
- Stipulate the oversight process for compensation consultants.
- Enumerate the factors that must be considered when setting compensation, including benchmark data, qualifications, and an organization’s overall financial condition.

Perhaps more immediately, nonprofits subject to the Act await guidance from the Attorney General about how to interpret and apply it. Although such guidance presumably would not have the force of law, it might help answer some of the many questions that organizations and their legal advisors are pondering. For example:

- What it means for a related party to have a “substantial financial interest” in a transaction.
- Whether all policy violations (e.g., the investment policy or a policy on sexual harassment or deaccessioning works of art) are reportable under the whistleblower policy.
• What it means for an audit committee or board to “oversee . . . compliance” with the conflict of interest policy.
• How to apply the conflict of interest rules to affiliates in a complex organizational structure involving many entities in multiple jurisdictions.

The Future Generally
New action on nonprofit governance may occur in other states as well, particularly with regard to transactions with insiders and executive compensation. In Florida, HB 629 was signed into law. It requires (among other things) certain charitable organizations to:
• Adopt a policy concerning a defined class of “conflict of interest transactions” (The bill does not specify what the policy must be, except that officers and board members will be required to certify compliance annually.)
• Provide charities regulators with a copy of the conflicts policy.
• Make public disclosures about compensation, travel expenses, “overhead,” and certain transactions with organization insiders, provided that less than 25% of total expenses are devoted to “program service costs.”

In Massachusetts, Attorney General Martha Coakley issued a report entitled Massachusetts Public Charities CEO Compensation Review in December 2013.1 Having closely studied compensation practices at 25 of the largest public charities in Massachusetts, including Harvard and MIT, Coakley concluded that “sustained focus” by compensation committees on the details of compensation packages and comparability data for senior executives “can lead to a loss of perspective” about how their pay compares with other segments of an organization’s workforce or the workforce at large. Accordingly, she said she favored a compensation analysis that takes into account the charity’s operations, workforce, mission, and expenditures. She expressed the belief that such an approach “may help compensation committees moderate the rate of increase in executive pay.”2

Accordingly, Coakley said her agency would be issuing a revised compensation schedule for nonprofits that file annual reports in Massachusetts. Based on her report, it seems the state will ask organizations:
• Whether compensation committees are also evaluating the reasonableness of other segments of the charity’s workforce.
• Whether the compensation process takes into account the relative magnitude of the CEO’s total compensation package in relation to the organization’s non-executive workforce.
• Whether the compensation process takes into account the level of public support the charity enjoys in the form of exemption from property tax and other forms of taxation.

As the sector has seen with the Yes/No questions that the IRS added to its Form 990, the mere fact that a question is being asked is likely to drive behavior. And in this case, the behavior desired by the Massachusetts Attorney General represents a departure from the traditional focus on comparability and market reasonableness. This is a foray into fundamental issues of fairness and equity. One wonders if other states will start asking the same sorts of questions, or if some state might go so far as to require the consideration of such elements.

It took a decade to move from “Integrity” in California to “Revitalization” in New York. Time will tell whether “Compensation Fairness and Equity” becomes the next frontier in nonprofit governance. In the meantime, the Non-Profit Revitalization Act should give every observer and student of nonprofit governance a great deal to parse and to ponder, including whether it lives up to the promise of its name.

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1 http://www.mass.gov/ago/docs/nonprofit/ceocomp/ec-review.pdf
2 Massachusetts Public Charities CEO Compensation Review, p. 79
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