New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 254—NO. 21
FRIDAY, JULY 31, 2015

Outside Counsel

Expert Analysis

Attorney General Issues Guidance On State Not-for-Profit Law

By **Roger Cohen**

And **Ellen Moskowitz**

On April 13, 2015, the New York Attorney General's office released two guidance documents addressing key provisions of the New York Not-for-Profit Corporation Law (the N-PCL) enacted as part of the Nonprofit Revitalization Act of 2013 (the NPRA).[1] The first document provides guidance concerning N-PCL §715-a, a provision of NPRA that requires not-for-profit corporations to maintain conflict-of-interest policies and establishes minimum requirements for such policies. Interestingly, the conflict-of-interest policy guidance extends its focus beyond the conflict-of-interest provisions of N-PCL §715-a, to, apparently, in an exercise of enforcement discretion, exempt certain arrangements from NPRA's related party transaction requirements set forth in N-PCL §715. The exempted arrangements are generally described as those not usually requiring board action or approval.

The second document provides guidance concerning N-PCL §715-b, which requires certain not-for-profit corporations to maintain whistleblower policies and establishes requirements for such policies.

Where the guidance documents generally reiterate the statutory requirements, the documents provide some useful, plain language insight. Where the guidance appears to extend beyond statutory language, as in the case of the exceptions offered to the related party transaction requirements, the attorney general's enforcement relief is noteworthy, but certain ambiguities in the guidance language suggest that it would be prudent to proceed with caution in adopting policies based on the guidance.

> One document provides guidance concerning a provision that requires not-for-profit corporations to maintain conflict-of-interest policies and establishes minimum requirements for such policies.

Highlights of these documents follow.

Conflict-of-Interest Policy

Related Party Transactions. N-PCL §102(a)(23) generally defines a related party as (i) a director, officer or key employee of the corporation or an affiliate of the corporation; (ii) a relative of any such person; or (iii) an entity in which any such person has certain specified ownership or beneficial interests (e.g., a 35 percent or greater ownership interest). N-PCL §102(a)(24) defines a related party transaction as a transaction, agreement or other arrangement in which a related party has a financial interest and in which the corporation or an affiliate is a participant

Pursuant to N-PCL §715-a(b)(6), a conflict-of-interest policy must contain "procedures for disclosing, addressing, and documenting related party transactions in accordance with [the N-PCL provisions concerning related party transactions]." N-PCL §715, which addresses related party transactions, provides that "[n]o corporation shall enter into any related party transaction unless the transaction is determined by the board to be fair, reasonable and in the corporation's best interest at the time of such determination."

In addition, with respect to any related party transaction involving not-for-profit corporations that are "charitable corporations" within the meaning of the N-PCL and in which a related party has a "substantial financial interest," the board of the corporation must "[c]ontemporaneously document in writing the basis for the board or authorized committee's approval, including its consideration of any alternative transactions."

We have previously noted that because of the apparent breadth of the NPRA requirements concerning related party transactions, compensation arrangements with officers and executive employees could, potentially, be considered related party transac-

ROGER COHEN *and* ELLEN MOSKOWITZ *are senior counsels at Proskauer Rose.* KRISTA L. WHITE*, a summer associate at the firm, assisted with the preparation of this article.*

tions, although the separate N-PCL regulation of compensation approvals, under N-PCL §515(b), would seem to indicate that additional regulation under the N-PCL §715-a related party rules would be questionable.[2]

The attorney general's guidance not only purports to exempt these compensation relationships from the related party requirements, but also exempts additional specified transactions. Specifically, the guidance notes that the "record-keeping requirements of section 715 of the N-PCL…may not apply to four types of transactions" because those transactions "are of a sort that does not usually require board action or approval."

The four types of transactions are: (1) de minimis transactions; (2) transactions or activities undertaken in the ordinary course of business by staff of the organization; (3) benefits provided to a related party solely as a member of a class that the corporation intends to benefit as part of the accomplishment of its mission; and (4) transactions related to compensation of employees or directors or reimbursement of reasonable expenses incurred by a related party on behalf of the corporation.

One uncertainty in the guidance concerns the extent to which the guidance exempts the four categories of transactions from all, and not merely some, of the N-PCL requirements applicable to related party transactions. Specifically, the guidance states that the "record-keeping requirements of section 715 of the N-PCL" may not apply to such transactions. This seems to suggest that board approval and, where applicable, consideration of alternative transactions, may be required.

Elsewhere, however, the guidance states more broadly that "the statutory process mandated by section 715 of the N-PCL" may not apply to transactions in the four identified categories. This indicates that none of the requirements under N-PCL §715 apply to such transactions. Given the emphasis in the guidance that the transactions in the four categories do "not usually require board action or approval," the latter interpretation seems more reasonable (otherwise, the guidance would require board approval of transactions that do not ordinarily require board approval).

With respect to compensation arrangements, the guidance notes that "[t]ransactions related to compensation of employees, officers or directors…are not considered related party transactions, unless that individual is otherwise a related party based on some other status, such as being a relative of another related party." If compensation arrangements are flatly "not considered related party transactions," then it would appear that neither the board approval nor the documentation requirements under N-PCL §715 should apply to such transactions.

We note that while it seems correct to carve out compensation arrangements from the related party procedures, the guidance's rationale for doing so raises some concern. The guidance suggests that the basis of this exemption is that compensation afforded to directors or executive employees is reasonably characterized as not typically subject to board action or approval. This rationale seems questionable, however, in light of the now common practice, prompted by concerns associated with IRS intermediate sanctions, of having exempt organization boards or board committees review and approve executive compensation.

> N-PCL §715-b requires not-for-profit corporations with 20 or more employees and annual revenue in excess of $1 million to adopt whistleblower policies to prohibit retaliation against employees who report "in good faith" action or suspected action that is illegal, fraudulent, or in violation of "any adopted policy of the corporation."

With respect to a "de minimis" transaction, the guidance takes a relative approach, stating, "[w]hat constitutes a "de minimis" transaction will depend on the size of the corporation's budget and assets and the size of the transaction. A transaction that merits review by the board of a smaller corporation might not merit review by the board of a larger organization."

The guidance notes that a transaction qualifies as an "ordinary course" transaction if it is "consistent either with the corporation's consistently applied past practices in similar transactions or with common practices in the sector in which the corporation operates." The guidance offers several examples of such a transaction, including, for example:

- A nonprofit hospital uses the local electric utility for its electrical service and supply, and a 35 percent shareholder of the local electric utility is a member of the board;
- A relative of a board member is hired for a paid summer internship following the review of a resume and interviews which are conducted in accordance with the corporation's typical procedures; and
- A director of a hospital is a partner at a law firm and the hospital retains the law firm in accordance with a written, established, and enforced policy for the selection, retention, evaluation, and payment of outside counsel.

Notably, the guidance suggests that the provisions of N-PCL §715-a, regarding conflicts procedures, may continue to apply to transactions in the four identified categories, noting that related parties "may not intervene or seek to influence the decision-maker or reviewer in these transactions. The decision-maker, and those responsible for reviewing or influencing these transactions, should not consider or be affected by a related party's involvement in decisions on matters that may affect the decision-maker or those who

review or influence the decision."[3] This appears to reference statutory requirements of N-PCL §715-a(b)(3) and (4), but again, this is not clear.

Another area of uncertainty is that the attorney general's guidance concerning the four categories of transactions that may be exempt from certain requirements for related party transactions is somewhat equivocal in that the guidance only states that such requirements "may not apply," which seems to suggest that the requirements may apply in some instances.

In light of the foregoing, it would be prudent for not-for-profit corporations to proceed cautiously if implementing the attorney general's guidance concerning related party transactions.

Avoiding Improper Influence. Under N-PCL §715-a(b)(4), a conflict-of-interest policy must prohibit "any attempt" by a person with a conflict "to influence improperly the deliberation or voting on the matter giving rise to such conflict." The phrase "influence improperly" is not defined, however. The guidance document clarifies that the phrase should be understood to mean "coercing, manipulating, misleading, or fraudulently influencing… the decision-making when the officer, director, or other person knew or should have known that the action, if successful, could result in the outcome which the officer or director could not deliberate or vote on directly." The guidance draws this definition from the Securities and Exchange Commission's definition of improper influence on an audit.

Whistleblower Policies

N-PCL §715-b requires not-for-profit corporations with 20 or more employees and annual revenue in excess of $1 million to adopt whistleblower policies to prohibit retaliation against employees who report "in good faith" action or suspected action that is illegal, fraudulent, or in violation of "any adopted policy of the corporation." The policy must be distributed to all directors, officers, employees, and volunteers who provide substantial services to the corporation. The guidance clarifies the scope of alleged policy violations that trigger protection from retaliation pursuant to N-PCL 715-b, what constitutes a "good faith" report, and permissible means of distributing the policy.

Scope of Alleged Policy Violations Triggering Whistleblower Protection. The guidance states that "[a]dopted policies as to which a nonprofit must provide whistleblower protection include, without limitation, policies formally adopted by the nonprofit's governing body that are designed to: prevent financial wrongdoing, such as internal and external financial controls, accounting policies, and policies prohibiting fraud, theft, embezzlement, bribery, kickbacks, and abuse or misuse of corporate assets; conflict of interest policies; policies addressing unethical conduct; and harassment and discrimination policies." Since the list is not exclusive, the guidance reflects that allegations concerning the violation of other policies may trigger whistleblower protection as well.

The guidance notes, however, that some whistleblower complaints concerning violations or suspected violations of an adopted policy "may not be entitled to whistleblower protection." As an example, the guidance cites a complaint concerning violation of a dress code set forth in an employment manual adopted by the board. This guidance appears to evince a sensible approach to the kind of whistleblower conduct that will be protected.

Good Faith. The guidance notes that a "good faith" report is "one which the whistleblower reasonably believes to be true, and reasonably believes to constitute illegal conduct, fraud, or a violation of an organization's policy." The guidance adds that the good-faith analysis does not focus on the whistleblower's motive but instead on the existence of the violation or suspected violation. Thus, a person who reported a violation of law or a policy and genuinely believed that the reported misconduct occurred, but was in part motivated by some personal animus, would be acting in good faith under the guidance. In contrast, someone who complained of conduct that violated law or a policy but made the complaint knowing it had no basis in fact would not be acting in good faith.

Helpfully, in the section discussing the meaning of good faith, the guidance notes that a whistleblower policy may provide that a person will not necessarily "get immunity for participating or being complicit in the violation or suspected violation that is the subject of her or his report or subsequent investigations."

Distribution of the Policy. As noted above, a corporation that is subject to the whistleblower policy requirement must distribute the policy to all directors, officers, employees, and volunteers who provide substantial services to the corporation. The guidance helpfully notes that this requirement may be satisfied by posting the policy on "the organization's publicly available website." Presumably posting the policy on an intranet available to all covered persons would be consistent with the guidance despite its reference to a "publicly available website."

1. "Conflicts of Interest Policies Under the Nonprofit Revitalization Act of 2013," New York State Office of the Attorney General, available at http://www.charitiesnys.com/pdfs/Charities_Conflict_of_Interest.pdf; "Whistleblower Policies Under the Nonprofit Revitalization Act of 2013," New York State Office of the Attorney General, available at http://www.charitiesnys.com/pdfs/Charities_Whistleblower_Guidance.pdf.

2. See New York Nonprofit Revitalization Act Rollout Challenges, Proskauer Rose Client Alert (June 20, 2014), available at http://www.proskauer.com/publications/client-alert/new-york-nonprofit-revitalization-act-rollout-challenges/

3. The guidance also specifically notes that compensation arrangements with related parties must be reasonable, and the interested person may not participate in deliberations or vote on the arrangement.