REVITALIZING NEW YORK’S NONPROFIT ORGANIZATIONS
Revitalizing New York’s Nonprofit Organizations

On February 16th, 2012, the New York Attorney General released a new proposal to improve the nonprofit landscape and revitalize nonprofit organizations in New York State. The report, created and assembled by a group of 32 nonprofit leaders, the Leadership Committee for Nonprofit Revitalization, outlined the steps that the State of New York and the Office of the Attorney General should take to reduce burdens on nonprofits as well as enhance governance and oversight.

The Leadership Committee developed 37 sweeping recommendations, touching on everything from executive compensation and board oversight to policies and procedures and board member training. The recommendations are separated into two sections, the first section focuses on how to reduce burdens for nonprofits, the majority of which should be addressed at the state level. These changes would not impact a nonprofit’s internal policies, but nonetheless could mean that an organization would have an easier time getting contracts approved and receiving funding from the state. In the spirit of these goals, on May 2, 2012, it was announced that Governor Cuomo named Fran Barrett as InterAgency Coordinator for Not-for-Profit Services, where she will serve as liaison between the state and the nonprofit community. Barrett is charged with responsibility to help coordinate state’s procurement and contracting systems and address challenges nonprofits face in their business relationships with state agencies.

The second section of the recommendations focuses largely on improving governance and transparency within nonprofits. While these changes could ultimately benefit most, if not all, organizations, adapting to these new recommendations (if they are adopted) would mean significant changes to the way that many nonprofit organizations currently operate. Since, as in most cases, one size does not fit all, the recommendations should be carefully considered in light of the many different types of organizations to which they would apply.

After examining the report in its entirety, we have identified the impact of the enhanced governance recommendations. In addition to creating an overview of the five key sections of the enhanced governance recommendations, we have also noted (from a relative sense) the approximate amount of time that an organization would need to devote in order to implement the recommendation. The at-a-glance guide also highlights the types of organization each recommendation would impact the most.
Legend

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<tr>
<th>Recommendation Level</th>
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<td>A specific recommendation would take an organization little time to successfully implement</td>
<td>Small organizations would be impacted the most</td>
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<td>A specific recommendation would take an organization significant time to successfully implement</td>
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The 5 key sections of the enhanced governance recommendations include:

- Board Oversight over Executive Compensation and Financial Audits
- Self-Dealing and Illegality
- The Distinct Roles of Management and the Board
- Recruiting the Next Generation of Board Leaders
- Promoting Director Education

### Board Oversight over Executive Compensation and Financial Audits

The board plays a key role in governing an organization and creating a positive and ethical “tone from the top” culture. One area of focus for the Leadership Committee was limiting excessive compensation. Recently, investigations into nonprofit organizations have exposed particularly egregious levels of compensation for several nonprofit leaders. However, New York State does not currently have any criteria or process enabling nonprofits to evaluate what is “reasonable compensation.” (Many organizations use federal tax rules and IRS published guidance as a measure of appropriateness.)

In addition, the board of a nonprofit should also be involved with an organization’s audit as a means to ensure that financial issues are more likely to be addressed. Most public companies are required to have an independent audit committee, but this is not the case with nonprofits. In New York, only certain organizations, such as those who raise more than $250,000 through donations or grants, are required to receive a certified audit every year. (Organizations with revenue of more than $100,000 but less than $250,000 are required to have an audit review).
1) Require Independent Board Oversight over Executive Compensation
Independent directors would be required to annually review the pay of CEO, CFO, and other key employees to determine if it is “reasonable”. The state would also need to define “independent directors.”

This recommendation should be straightforward to implement. Either all of the independent directors or a committee of the board comprised of some of the independent directors would be responsible for this action. Under New York law, however, the full board would remain responsible for the actions of the committee. Even though the leaders of large organizations tend to have the largest compensation packages, this recommendation would impact organizations of all sizes.

Amount of Time

Who is Impacted the Most?

2) Set Forth Criteria for Board Review
Board oversight on executive compensation would expand into: criteria for board review, including review of everything from total compensation relative to organizations of a similar size and type, employee qualifications and performance, and any issues impacting an organization’s financial standing.

While many organizations already have an evaluative device, this measure would standardize the process and make every nonprofit board use the same core criteria for evaluating compensation packages. This recommendation would most likely impact smaller organizations that may not have criteria for board reviews and would need to devote time and financial resources to get up-to-speed. Due to significant differences among the types of nonprofits, it may be difficult for the state to legislate “one size fits all” criteria. Thus, ambiguity may nevertheless remain.

Amount of Time

Who is Impacted the Most?

3) Require Contemporaneous Documentation of Board Action Regarding Compensation Decisions
This recommendation calls for the altering of New York State law to require contemporaneous documentation of any board action in connection with compensation matters. In short, an organization would need to document compensation review processes in board records providing clear justification for its decisions.

As with compensation evaluation, many organization boards should already include their analysis of compensation evaluation in their board records. This recommendation would most likely impact smaller organizations that may not currently evaluate compensation nor document how they evaluate compensation.

Amount of Time

Who is Impacted the Most?
4) Require Oversight of Compensation Consultants
This recommendation would require organizations that use outside compensation consultants to adopt policies and procedures that outline how these consultants are selected, retained, and overseen. In addition, boards would be responsible for proving a consultant’s independence, which would be defined under New York State law.

Medium and large nonprofit organizations are most likely to use outside compensation consultants, and with this new recommendation, they would need to develop and modify new board policies and procedures. This recommendation could have a substantial impact on many small and midsized organizations in particular, since it is not uncommon for such organizations to look toward their accountants to provide this type of advice and data.

5) Require that Boards Perform the Audit Committee Function
As it currently stands, nonprofits that are required to obtain an annual financial audit are free to conduct the audit as they see fit. This recommendation would require that boards perform the audit committee function, either by a committee of independent directors or by independent directors on the board. This recommendation would also outline functions of the audit committee as well as criteria to evaluate director independence.

This recommendation may discourage board participation, particularly in smaller nonprofit organizations. Overall, this recommendation would impact small and medium nonprofits the most, as they currently have less defined procedures surrounding their financial audits.

6) Require Boards to Adopt Audit Oversight Charters
The recommendation would require boards of nonprofits that obtain external financial audits to adopt charters that set oversight functions. Specifically, oversight charters would outline procedures for oversight as well as requirements for independence.

Adopting a charter should be a single endeavor and not a time-intensive process. Small and medium nonprofits will be impacted the most, but this recommendation should require minimal effort to implement, particularly since small nonprofits do not normally have their financial statements audited.
7) Initiate Director Training on the Audit Committee Function
In addition to getting the board more involved in the auditing process, it is also helpful for all nonprofit directors to understand the role of an audit committee. The recommendation would require the Office of the Attorney General to work with leaders in the accounting field to develop training programs for all directors of nonprofits. Many larger nonprofits already have their own training programs and generally have more flexibility in sending their board members to additional training. Implementing this proposal may present logistical issues for the state in order to maintain quality control, as well as a monitoring system to ensure compliance with the mandate. The cost to implement this portion of the recommendation may also be an issue, specifically, with respect to whether the state would assume the cost and/or whether nonprofits or their directors would be required to incur fees to attend training.

Amount of Time

Who is Impacted the Most?

Protect against Self-Dealing and Illegality
Organizations in the nonprofit sector are open to public scrutiny by the nature of their work. Every organization must actively work to prevent the misappropriation of assets. Board members, directors and employees that abuse the system tarnish the public perception of all nonprofit organizations, even if the offending group is small in comparison.

There are several steps that the state can take to increase oversight and provide government officials with the power they need to enforce regulations.

8) Enhance the Attorney General’s Power to Police Self-Dealing
Although New York law already imposes fiduciary duties on directors with respect to transactions conducted with interested parties, it has been recommended that the Attorney General be granted specific power to commence actions to challenge interested-person transactions and, if necessary, to unwind such transactions.

Until the specifics behind the Attorney General’s additional authority become better defined, it is difficult to know how this recommendation will impact nonprofit organizations. This recommendation could discourage board participation in small nonprofits, but the degree to which this recommendation will change nonprofit operations will depend largely on the details of the Attorney General’s new power.
9) Require a Determination that Interested-Person Transactions are Fair and Reasonable

One method permitted under New York law which allows a transaction to be conducted with an interested party requires that the transaction’s terms be “fair and reasonable”. It has been recommended that an affirmative duty be imposed upon the Board to make this determination and, presumably, document such determination. It has also been recommended that these rules apply to “key employees” (as reported on IRS Form 990).

Although all nonprofits should currently be engaging in this practice, the proposed change would likely impose a set of criteria for determining when a transaction is fair and reasonable. Creating a set of criteria in a “one size fits all” manner may prove to be difficult. These rules will likely impact small and midsized nonprofits the most, as these organizations are more likely to be heavily reliant on obtaining discounted services from interested parties. Presumably the proposed changes would require nonprofits to prove that the transaction is being conducted on a “discounted” basis. Although many situations may appear obvious, nonprofits may find themselves spending significant time to create a record to support such transactions.

10) Require Conflict-of-Interest Policies

The IRS has been promoting the implementation of conflict of interest policies by tax-exempt organizations for several years by providing a sample form for organizations to use. Such policies are useful in providing certainty for an organization with respect to the manner in which conflicts are to be addressed. Compliance with these proposals should not be onerous, yet one concern that arises is whether a form proposed by the Attorney General will be treated as the “default” required form, thereby usurping an organization’s ability to craft policies that meet the needs of the organization.

11) Require Whistleblower Policies

The IRS has also been promoting the implementation of whistleblower policies by tax-exempt organizations, including a question regarding whistleblower policies on the IRS Form 990. While most large and mid-sized nonprofits likely have already implemented such policies, smaller organizations with small staff may find practical limitations in adopting an effective policy. Again, with the added proposal that a “forms bank” be made available to nonprofits for use, one must be concerned that such forms may be viewed by the State as the “default” required forms that organizations must use.
Delineate the Distinct Roles of Management and the Board

While boards are responsible for managing nonprofit organizations, they typically delegate day-to-day responsibilities to full-time employees. In an ideal structure, the board sets a strategic direction and provides guidance, while the organization’s leadership team executes on the board’s goals. In recent years, however, the balance of power has shifted and the organization’s leadership team, particularly if it includes a founding executive, has increasing influence and sway over the board’s decisions.

By properly delineating roles of management and the board, New York State is taking action to restore a proper balance of power. While success of this specific initiative depends largely on a cultural shift in the nonprofit area, there are two specific legislative changes that can aid this measure.

12) Promote Independent Board Leadership
One of the most sweeping recommendations made in the report, if enacted, would prohibit organizations from permitting any paid employee, including the chief executive, from serving as the chair of the Board. This proposal will likely impact small organizations the most as it is not uncommon for an individual to start a nonprofit to address an unmet need in the community. During the early years of an organization, recruiting directors is typically a difficult process and a founder often relies on friends, family and business associates. In the earliest stages, it is entirely common for the founder to be the driving force behind the survival of the organization. If this proposal is enacted, many new organizations may face even greater challenges since they will be required to recruit a chair who has the same level of commitment to the work of the organization as the founder.

Who is Impacted the Most?
[Image]

13) Require Policies on Board Independence
In addition to the changes discussed above, the committee has also recommended that specific procedures be adopted by nonprofits with respect to paid employees: (a) serving on the Board, (b) when they may have voting rights, (c) percentages of the Board that must be independent, etc. In light of the recommendations already made in the report, these recommendations may be redundant. In order to implement these recommendations, substantial changes to the current law will be required since under the law, all Board members, generally, have one vote for each matter before the Board.

The impact of this recommendation is difficult to estimate and until specific changes to the current law are definitely made. It is likely this recommendation could discourage board participation in small nonprofits, but it is hard to know what specific impact these policies will have on boards and nonprofit organizations overall.

Who is Impacted the Most?
[Image]

Recruit the Next Generation of Board Leaders

Restoring a proper balance of power between management and nonprofit boards is a strategic tactic as nonprofit organizations will only be as strong as the board that oversees them. While New York State has a robust, diverse business environment, there is a continual demand for board members to assist growing nonprofits by providing their leadership and expertise. The biggest impediment to these proposed
recommendations being instituted throughout the state is the overall program cost. However, if a universal board recruitment system were to be implemented, new board members could be directed towards the organizations and roles where they would be the most helpful and provide the most value.

14) Launch New York on BOARD
This requirement would create New York on BOARD, a new program designed to encourage New York companies to: (a) expand their existing philanthropic programs to include board service by employees, (b) sponsor employee board service, by, for example, making contributions to organizations to which employees serve, and (c) incentivize board service, by, for example, recognizing service in employee performance reviews. While many other recommendations would mean significant changes for nonprofits, New York on BOARD would only further support the work of nonprofit organizations with respect to the recruitment of board members. As such, this recommendation will likely impact small organizations the most, as they are typically the organizations with the fewest opportunities to recruit qualified board members.

Amount of Time

Who is Impacted the Most?

15) Expand New York on BOARD to Additional Communities
This recommendation would grow New York on BOARD to include Boomers on BOARD and Academia on BOARD, both of which would help tap into different markets. Members of academia as well as the retiree communities could be assets to nonprofit organizations, and the expansion of the New York on BOARD program would help target these two distinct groups. As with the recommendation to create New York on BOARD, expanding the program further helps organizations attract board members. Additionally, this expansion initiative would also help small organizations, as they would be the first to see the direct benefit of this larger, more diverse program.

Amount of Time

Who is Impacted the Most?

16) Develop a Database to Match Directors with Nonprofits
This recommendation would charge New York on BOARD with developing an online database to match individuals wishing to serve as directors of nonprofit organizations. As with the two other New York on BOARD recommendations, this suggestion would impact smaller organizations the most.

Amount of Time

Who is Impacted the Most?

Promote Director Education
Instituting a program to recruit board members helps improve one aspect of nonprofit organizations, yet equally as important is training individuals who will serve in those positions. By promoting education and training for board members, New York State is taking yet another step to improve the nonprofit sector and provide nonprofit organizations with the tools that they need in order to succeed. As with board member
recruitment, board member training programs would also require a significant cost to successfully implement and maintain.

**17) Launch Directors U**
Directors U, a partnership between universities and nonprofit organizations, would serve as a forum to train and educate nonprofit leaders to serve as effective board members. Directors U would build off of existing training material already offered at the state level and would also include an online repository of training material.

**18) Incentivize Participation**
Directors U should work to incentivize participation from nonprofit leaders. While executive directors, board members and other nonprofit leaders are not explicitly required to participate in the Directors U program, organizations that have many members participate can be given recognition, which would serve to elevate these organizations in the eyes of donors as well as the public.

**19) Develop and Disseminate Best Practice**
Directors U provides the Attorney General an opportunity to develop and promote industry-wide best practices for nonprofit organizations. Topics such as board composition, the role of the board chair, and financial oversight can all be covered in Directors U and helps nonprofit organizations learn about and implement these best practices.

**20) Create a Repository of Model Documents**
In addition to education nonprofit on industry-wide best practices, Directors U can be used to create a central repository for nonprofit documentation. Directors U can create an online database of standard governing documents, in addition to various policies and procedures.
Conclusion

The Leadership Committee’s proposal to improve New York’s nonprofit landscape is vast, including 37 separate recommendations. If all the recommendations were implemented, the New York State environment could be that much more attractive for nonprofits. Enhancing governance, increasing oversight and reducing burdens on nonprofits are not miniscule issues, and continued efforts will be needed to adopt these policies into law. On April 13, 2012, Senate Bill Number S6930 was referred to the Investigations and Government Operations Committee. The Bill, in substance, includes the proposals described above, and in some cases, goes further in its mandate. Though substantial debate and revision may be expected, it is clear that there is an interest in moving these proposals towards the law of the State of New York.

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