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Potential Amendments to the Nonprofit Revitalization Act of 2013: New York State Legislature Adopts Bill which would Significantly Reform the Related Party Transaction Rules Under the Nonprofit Revitalization Act

On June 16, 2016, the New York State Legislature adopted yet another round of modifications to the Nonprofit Revitalization Act of 2013 (the "NPRA"). The latest revisions to the NPRA are found in Senate Bill No. S07913B (the "Bill"). Although the Bill has not yet been signed into law by Governor Andrew Cuomo, there is no indication that the Bill will not eventually become law.

Similar to previously adopted amendments to the NPRA, the Bill addresses issues that have arisen in the practical application of the NPRA. Most significantly, the Bill includes important changes to the NPRA's provisions regarding related party transactions, including revisions to the definitions of related parties and key employees. In addition to these significant changes, the Bill also includes a number of amendments that impact (1) the definition of interested directors; (2) the formation, composition and authority of committees; (3) the role of audit committees; (4) certain procedural aspects of conflict of interest and whistleblower policies; and (5) the ability of a corporation's employee to serve as chair of the corporation's board. A brief summary of these additional changes can be found here.

The related party transaction rules enacted by the NPRA left many organizations struggling with statutory language that, if read literally, requires all related party transactions to be approved by an organization's board of directors before the organization may enter into the transaction. Specifically, Not-for-Profit Corporation Law ("NPCL") Section 715(a) states: "No corporation may enter into any related party transaction unless the transaction is determined by the board to be fair, reasonable and in the corporation's best interests at the time of such determination." (emphasis added). This restriction proved to be onerous and burdensome as it required transactions that would not typically require board approval to be reviewed and approved by the board, without expressly allowing for committee approval to take the place of board review.

In April of 2015 the New York Attorney General's Office attempted to address some of these concerns by issuing guidance regarding conflict of interest policies under the NPRA (the "AG Guidance"). The AG Guidance provided that certain related party transactions, including transactions considered to be *de minimis* and transactions entered into in the ordinary course of business, would be exempt from the "record keeping requirements" of Section 715 of the NPCL, but that both the related party and decision maker would still be subject to other obligations under governing law related to the actual approval of such transactions. However, the AG Guidance was issued without statutory authority to support the exceptions to the related party transaction rules that it created, leaving practitioners and nonprofits unsure as to whether the exceptions could be relied on.

An additional concern created by the NPRA's related party transaction rules was whether an organization's board had the authority to ratify a related party transaction after the organization had already entered into the transaction. This situation frequently arose in instances where an employee, such as a facilities manager, had certain contracting authority delegated either by the board or a higher ranking officer and unknowingly entered into a related party transaction without the requisite board approval. The statutory language enacted by the NPRA prohibits all related party transactions without prior board approval of the transaction, and does not expressly contemplate the ratification of a transaction entered into in violation of this prohibition.

The Bill would enact several changes that would alleviate these and other concerns regarding the NPRA's related party transaction rules. Specifically, the Bill would amend the related party transaction rules by (1) formally adopting several express exceptions to the rules, (2) expressly allowing for committee approval of related party transactions and (3) expressly allowing an organization to ratify a related party transaction after it was entered into. Additionally, the Bill would revise the definition of "related party" and "key employee" in an attempt to clarify who is a related party under the NPCL. These changes re discussed below.

Exceptions for *De Minimis* and Ordinary Course Transactions

The Bill would incorporate *de minimis* and ordinary course of business exceptions into the NPCL Section 102(a)(24) definition of "related party transaction". Specifically, the Bill states that (1) if "the transaction or the related party's financial interest in the transaction" is *de minimis*, or (2) if the transaction is of a type the organization's board or boards of similar organizations would not review "in the ordinary course of business and is available to others on the same or similar terms", then the transaction is not a related party transaction. While these two exceptions are similar to those set forth in the AG Guidance, there are several important distinctions. First, the AG Guidance only addressed *de minimis* transactions from the perspective of the nonprofit organization, whereas the Bill also includes transactions where the related party's financial interest in the transaction is *de minimis*, making this appear to be a broader exception. Second, the Bill would qualify the ordinary course of business exception to include only those transactions that would be available to others on the same or similar terms, a qualification not included in the AG Guidance. Third, and likely most importantly, the Bill would completely exclude these two categories of transactions from the definition of related party transactions, whereas the AG Guidance only expressly excluded these types of transactions from the NPCL's record keeping requirements. It should also be noted that the Bill does not define the terms "*de minimis*" or "ordinary course of business"; however, despite the differences noted above, the AG Guidance should remain a useful reference in interpreting these terms.

Additionally, similar to the AG Guidance, the Bill would also exclude from the definition of related party transactions any transaction that provides a benefit to a related party solely as a member of a class of the beneficiaries the organization intends to benefit as part of the organization's mission and on the same terms as the benefit is available to similarly situated members of the same class.

Committee Approval of Related Party Transactions

The Bill would amend Section 715(a) of the NPCL to expressly allow an authorized committee of the board to approve related party transactions. As noted above, Section 715(a) currently provides that related party transactions are prohibited unless approved by an organization's board. Not only is this provision onerous because it requires board level approval of all related party transactions, it is also inconsistent with Section 715(b) which allows an authorized committee to conduct the required review of a related party transaction in which a related party has a substantial financial interest. The Bill would remove this inconsistency and lessen the burden placed on an organization's board by expressly providing that an authorized committee of the board may approve any related party transaction.

Ratification of Related Party Transactions

The Bill would add new Section 715(j) to the NPCL, providing nonprofits with ratification as a defense to an action initiated by the Attorney General alleging that the related party transaction rules were violated. This new section would allow a corporation to use ratification as a defense if (1) the transaction was fair, reasonable and in the best interests of the corporation at the time the corporation approved the transaction, and (2) prior to receiving any request for information regarding the transaction from the Attorney General, the board of the corporation has (a) ratified the transaction following the procedure that should have been utilized before the transaction was entered into, (b) documented in writing the nature of the violation and the basis for the board's or committee's ratification of the transaction, and (c) put into place procedures to ensure the corporation complies with the related party transaction rules in the future. (It should be noted that subpart (2)(b) of new Section 715(j) implies that a committee may ratify a related party transaction, but corresponding language elsewhere in the Section is limited to the board, creating perhaps yet another inconsistency in the statute that will need to be clarified by a later amendment.) Additionally, the Bill would add a new Section 715(i) that would provide that an organization may use the fact that a transaction was fair, reasonable and in the best interests of the corporation as a broad defense against any claimed violation of Section 715 brought by any person other than the Attorney General.

Definition of "Key Employee"

Finally, since the adoption of the NPRA there has been uncertainty as to who is a "key employee" under the NPCL, an important term used in the definition of "related party" which, in turn, impacts the definition of "related party transactions." This uncertainty generally revolved around the ambiguous terminology that a "key employee" was any person in a position to exercise substantial influence over the organization and the definition's reference to Internal Revenue Code and Treasury Regulation provisions governing excess benefit transactions. For example, based on the existing definition's reliance on the Treasury Regulations, a substantial donor to an organization could be a "key employee" even if the person was never employed by the organization. Further complicating the issue, amendments to the NPCL adopted in December of 2015 broadened the definition of "related party" to include "any other person who exercises the powers of directors, officers or key employees over the affairs of the corporation or any affiliate of the corporation." The existing ambiguous definition of "key employee" and the overly broad and vague definition of "related party" created uncertainty for organizations trying to determine when they were actually entering into a related party transaction.

The Bill attempts to resolve this issue by removing the language from the definition of "related party" that was added by the amendments adopted in December of 2015, changing the term "key employee" to "key person", and completely revising the definition of "key person." The new definition of "key person" would read as follows:

> "Key person" means any person, other than a director or officer, whether or not an employee of the corporation, who (i) has responsibilities, or exercises powers or influence over the corporation as a whole similar to the responsibilities, powers, or influence of directors and officers; (ii) manages the corporation, or a segment of the corporation that represents a substantial portion of the activities, assets, income or expenses of the corporation; or (iii) alone or with others controls or determines a substantial portion of the corporation's capital expenditures or operating budget."

This revised definition incorporates several of the factors set forth in the facts and circumstances tests of the Treasury Regulations governing excess benefit transactions for determining if a person is a disqualified person. The revised definition would eliminate redundancy found in the current definition (*e.g.*, under the current definition directors and officers are also key employees) and reduce ambiguity in the current definition of key employee.

Conclusion

The Bill includes a number of needed changes to the NPRA's related party transaction rules that have become apparent as New York nonprofits struggle to comply with these rules. By incorporating express exceptions, allowing for committee approval, authorizing ratification of past transactions and narrowing the universe of persons subject to the rules, the Bill has the potential to alleviate significant burdens placed on organizations. If the Bill is signed into law by Governor Cuomo, all New York nonprofits would be well advised to update their governance documents to incorporate these changes so that their governance documents do not prevent them from taking advantage of the Bill's provisions.

Click here for a link to the New York State Assembly Bill.

If you have any questions about this Information Memo, please contact Frank J. Patyi, Practice Group Chair, Scott R. Leuenberger, any of the attorneys in our Exempt Organizations Practice, or the attorney in the firm with whom you are regularly in contact.

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