

Article

**THE NEW YORK NONPROFIT REVITALIZATION ACT,
FROM THE FOUNDATION OF THE SARBANES-OXLEY ACT
TO IMPLEMENTATION**

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Introduction

Nonprofit organizations play a critical role by acting as a vessel to provide funding for projects that benefit society.¹ Services and grants in a wide variety of areas are important to institutions in the community, including healthcare, education, museums, and social-need organizations. The nonprofit sector has grown in size and diversity and has increased in prominence. More than 1.5 million nonprofit organizations are registered in the United States.² More than 92,906 of these nonprofits are active in New York,³ of which 74,269 are listed as 501(c) (3) nonprofit organizations. This non-exhaustive list includes public charities, private foundations, and other types of nonprofit organizations, including chambers of commerce, fraternal organizations, and civic leagues.

In the wake of news of scandals in nonprofit organizations, several states began to tout legislative solutions to the perceived notion of a nonprofit accountability gap. These legislative approaches followed the passing of the Sarbanes-Oxley Act of 2002 (“SOX”). The steps taken by the boards of for-profit organizations, including those required by Sarbanes-Oxley and related rules and regulations, have led to increased engagement on the part of board of directors.⁴

Stricter modifications of federal and state law regarding for-profit corporations have also been implemented. The new regulations for nonprofit corporations are not far disconnected from SOX regulations that were the foundation for their creation. More interesting, however, is the substantive link between these two sets of reforms, particularly the shared emphasis on the board of directors and fiduciary duties. Officers and directors are considered fiduciaries of the

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¹ Mark Sidel, *The Nonprofit Sector and the New State Activism*, 100 Mich. L. Rev. 1312, 1313 (2002) (book review) [hereinafter Sidel, *New State Activism*] (stating that the charitable sector is “integral to the national economy and a valued part of [our] social fabric . . . [It] embodies the philanthropic goodness, conviviality, cultural excitement, and democratic spirit of the American people . . . [and] has provided a valued social location in which groups can operate without pecuniary obsessions and with measures of success that are not necessarily related to financial profitability.” (quoting NORMAN I. SILBER, *A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE NONPROFIT SECTOR 2* (2001))).

² National Center for Charitable Statistics (NCCS).

³ *Id.*, refer to state profile and pull up New York.

⁴ Deloitte, *The Guide to Not-For-Profit Governance* 2012.

nonprofit organization that they manage.⁵ The fiduciary duties of the board of directors are articulated in the Nonprofit Corporation Law (“NPCL”) of New York.

This article argues that IRS regulatory influence through the Sarbanes-Oxley Act has influenced the strong, ethical, and transparent nonprofit board governance as implemented in the New York Nonprofit Revitalization Act (“Revitalization Act”). Part I examines how the New York government first mimicked SOX by using it as a foundation for the NPCL to regulate nonprofits. This section further compares the Revitalization Act and the SOX. Part II charts the evolution of the NPCL until it emerged, renamed the New York Nonprofit Revitalization Act. Part III gives recommendations to build on the existing reforms in the nonprofit sector.

I. Regulations of Nonprofits

A. Federal Regulations: IRS

Nonprofit law combines corporate law, tax law, and trust law.⁶ The law regulating nonprofit organizations is relatively new compared to the law regulating for-profit corporations.⁷ Ordinarily, a nonprofit is incorporated under a nonprofit corporation statute. Incorporation is not required to operate as a nonprofit; however, incorporating is wise when seeking favorable tax treatment under the Internal Revenue Code.⁸ The IRS prohibits acts of self-inurement and self-dealing for tax-exempt organizations. IRC §501(c)(3) requires that the 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. . . .”

The role of the board of directors for nonprofits began to be addressed in IRS filings starting in 2008,⁹ which placed an increased focus on the scope of the obligations of nonprofit directors.¹⁰ In 2007, the IRS released Form 990 that requires disclosures on corporate governance and board of directors, making the nonprofit’s governance a matter of public record.

A nonprofit in Form 990 must indicate whether the governing board reviewed the form before it was filed with the IRS¹¹ and must verify that the form was actually presented to the

⁵ Scheuer Family Foundation, Inc. v. 61 Associates, 179 A.D. 2d 65, N.Y.S.2d 662 (1st Dept. 1992); The Martha Graham School and Dance Foundation, Inc. v. Martha Graham Center of Contemporary Dance, 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).

⁶ Susan N. Gary, *Regulating the Management of Charities: Trust Law Corporate Law, and Tax law*, 21 U. Haw. L. Rev. 593 (1999) (discussing how trust law, corporate law, and tax law impact charities).

⁷ Kara A. Gilmore, *House Bill 1095: The New Nonprofit Corporation Law for Missouri*, 63 UMKC L. Rev. 633, 633 (1995) (“Nationally, nonprofit corporations have not received as much attention from lawmakers as for-profit corporations because the former do not impact the economic status of Americans as directly as for-profit corporations.”).

⁸ David S. Walker, *A Consideration of an LLC for a 501(c)(3) Nonprofit Organization*, 38 Wm. Mitchell L. Rev. 627 (2012) (“While the charitable trust form is an option and, for some, the unincorporated nonprofit association may be a viable choice, the ‘predominant’ form of charitable organization in the United States is the nonprofit corporation.”).

⁹ Karen Donnelly, *Good Governance: Has the IRS Usurped the Business Judgment of Tax-Exempt Organizations in the Name of Transparency and Accountability?*, 79 UMKC L. Rev. 163, 165-68, 181-91 (2010).

¹⁰ Grace Allison, *The New Form 990 for Tax Exempt Organizations: Revolution in Progress*, 37 Est. Plan. 14, 14-20 (2010) (discussing the enhanced Form 990 requirements and their effects on directors at nonprofits).

¹¹ I.R.C. Form 990, at 6, Question 11 (2011).

board prior to the IRS filing.¹² It further requires inclusion of a full description of the process for review by any of the organization's officers, directors, trustees, or management and disclosure of whether it was reviewed before or after it was filed with the IRS, which includes disclosure of who conducted the review, when it was conducted, and the extent of the review.

Other questions in Form 990 ask the nonprofit to address governance practices in setting executive compensation and disclosure of the number of independent voting members in the governing body.¹³ Also, the nonprofit must indicate whether its officers, directors or trustees, and key employees are required to annually disclose any personal interests that could give rise to conflicts.¹⁴ Additionally, Form 990 must disclose whether the process for determining CEO and other key officer and employee compensation includes a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision for the organization.¹⁵

Section 4958 applies to all organizations exempt under IRC sections 501(c)(3) (other than private foundations) and 501(c)(4). IRC §4958 proscribes "excess benefit transactions"¹⁶ between certain charitable organizations and "disqualified persons" (generally, those in a position to exercise "substantial influence" over the organization). Such regulations give the IRS 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. This legal doctrine was taken into consideration by the New York legislature for definitional purposes when drafting the Revitalization Act.

B. The Influence of Sarbanes-Oxley

SOX raised corporate governance standards of for-profit corporations. Regulators seized this opportunity to create similar reforms in nonprofit governance, in order to avoid further scandals.¹⁷ At the federal level such reforms quickly became moot; in fact the need for government reforms in nonprofits originated with tax laws rather than traditional corporate governance sources.¹⁸

SOX was passed in 2002 in the wake of corporate accounting scandals. Two criminal provisions apply to nonprofit organizations: provisions prohibiting retaliation against whistleblowers and provisions prohibiting the destruction, alteration, or concealment of certain

¹² *Id.*

¹³ Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 *Fordham L. Rev.* 795, 814-31 (2007).

¹⁴ I.R.C. Form 990.

¹⁵ *Id.*

¹⁶ An excess benefit transaction is one in which the economic benefit provided to the disqualified person is greater than the return itself to the applicable tax-exempt organization. IRC §4958(c)(1)(A).

¹⁷ Wendy K. Szymanski, *The Allegory of Good (and Bad) Governance: Applying the Sarbanes Oxley Act to Nonprofit Organizations*, 2003 *Utah L. Rev.* 1303, 1320-36 (2003).

¹⁸ Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 *Del. J. Corp. L.* 57, 60 (2009).

documents or the impediment of investigations.¹⁹ These two criminal provisions will not be discussed in this article. Instead this article focuses on the provisions of the board of directors, audit committee requirements, and auditor provisions of the SOX and how the revised amendments of the NPCL have made their way into the Revitalization Act, with definitional language changes and structural shifts.

Board of Directors Requirements

With the implementation of SOX, the focus shifted toward a perspective that management is working for the board of directors. Previously, it was common practice for the board of directors to act in service of the management. SOX further recognizes that director independence is necessary for the board to serve effectively as a check on management. SOX allows director liability if the board fails to exercise the appropriate oversight. This increased demand and need for independence has led to greater diversity among the people who serve on the boards. Furthermore, SOX mandates the creation of an audit committee.

Audit Committee Requirements

SOX requires that the audit committee of a company's board of directors appoint, compensate, and oversee the auditor's work.²⁰ Additionally, it mandates that each corporation create and maintain an independent and competent audit committee.²¹ This committee remains apprised of all "critical accounting policies and practices" used by the company's outside auditors.²² It requires that each member of the audit committee be an independent board member, which the act defines as "a person who holds a voting seat on the board but has no other stake in the corporation."²³ Further, the audit committee members may not be affiliated with the company or its subsidiaries, and they may not receive fees from the company beyond their compensation for serving on the board of directors and the audit committee.²⁴ The law also encourages companies to have financial experts on the audit committee by requiring companies to disclose whether their committees include at least one financial expert and, if not, the reasons why.²⁵

Auditor Provisions

SOX prohibits auditors from providing certain non-auditing services along with an audit; it requires the audit committee to pre-authorize the audit and permissible non-audit services (such as tax services, bookkeeping, actuarial services, management or human resources services, and legal services); and it requires that all audit committee approvals of non-audit services be disclosed.²⁶ It requires that the lead partner of a company's outside auditing firm be rotated off

¹⁹ See American Bar Association, Standing Committee on Pro Bono & Public Service and the Center for Pro Bono. Nonprofits and Sarbanes-Oxley, http://americanbar.org/legalservices/probono/nonprofits_sarbanes-oxley.html.

²⁰ Sarbanes-Oxley Act §301.

²¹ Stephen J. McNally & Joseph T. Steuer, *Case Study: Can Sarbanes Oxley Hold the Keys to Nonprofit Governance?*, WEBCPA, Feb. 2013, 2006, <http://www.webcpa.com/article.cfm?articleid=18822&print=yes>.

²² Sarbanes-Oxley Act § 204.

²³ *Id.* § 301(3).

²⁴ *Id.* §301.

²⁵ *Id.* §407(A).

²⁶ *Id.* §202.

the company's audit committee every five years²⁷ and prohibits an auditor from providing audit service to a company if the auditor employed the company's CEO, CFO, Chief Accounting Officer, or controller and such individual participated in any way in the audit of the company within one year before the initiation of the audit.²⁸ This provision is meant to minimize risk of collusion between the company and the auditor.²⁹ Third, SOX mandates that a top corporate officer certify the accuracy of the company's financial statements and holds this officer personally liable for fraudulent claims in these disclosures.³⁰ These provisions have given the audit committee greater powers and more responsibilities. Essentially, if the audit committee of the board does not address reports of misconduct from independent auditors, the independent auditors have the obligation to inform the SEC. This creates a check-and-balances system. It mandates increased communication between the audit committee and the auditor, placing responsibility for all aspects of the audit with the audit committee while enabling the auditor to act without any conflict of interest.³¹

SOX does not address "related party transactions" under the same microscopic view as the Revitalization Act does. In fact no such section exists. However, SOX does require both the board and the audit committees to review their existing codes of conduct or conflict of interest policies with particular focus on practices concerning related-party transactions. When dealing with related transactions, the audit committee may take an expansive view of what is considered a "related party" and focus on non-arm's length transactions in addition to relationships required to be disclosed by the SEC.

II. Not-for-Profit-Corporation Law in New York

New York Attorney General Andrew Cuomo continued the initiative to enact a nonprofit law that the previous attorney general, Eliot Spitzer, had begun. In 2010, two new governance rules amended New York's version of the Uniform Prudent Management of Institutional Funds Act, requiring (a) that organizations have a written investment policy and (b) that boards document the prudence analysis accompanying decisions to draw funds – even to appropriate the annual draw – from endowment.³² On September 17, 2010, New York governor David Paterson signed into law the New York Prudent Management of Institutional Funds Act ("NYPMIFA").³³ A year later, Attorney General Eric Schneiderman convened the Leadership Committee for Nonprofit Revitalization, which ultimately developed the New York NPCL and then later amended it to what is now the New York Nonprofit Revitalization Act ("Revitalization Act").

²⁷ *Id.* § 203. ("It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner . . . has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.")

²⁸ *Id.* §206.

²⁹ BoardSource & Indep. Sector, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* 5 (2003), available at <http://www.boardsource.org/clientfiles/SarbanesOxley.pdf>.

³⁰ Sarbanes-Oxley Act § 906(c).

³¹ Daniel L. Kurtz, *Nonprofit Governance* (2003).

³² New York Revitalizes: State Governance Reform for Nonprofits.

³³ New York Prudent Management of Institutional Funds Act, Ch. 490 § 1, 2010 N.Y. Laws 1334.

The Revitalization Act, passed in December 2013, took effect on July 1, 2014. It amended the NPCL and related laws affecting nonprofit organizations. The Act makes several changes to the laws governing New York nonprofits in an attempt to shore up board independence, improve accountability, and modernize outdated provisions. These new provisions apply to nonprofits that are incorporated in New York, but one significant section – related to financial audits and financial reporting to the state—applies to all nonprofits that are required to register in New York for charitable solicitation purposes. The focus of this article is those provisions dealing with independent governance, audit, and oversight. Under the NPCL, a nonprofit may have standing and special committees of the board in addition to committees of the corporation.³⁴ The Revitalization Act eliminates the concept of standing and special committees and clarifies that committees include committees of the board and committees of the corporation.

Audit Committee and Audits

Following the lead of the SOX and the IRS rules, the Revitalization Act places a great deal of focus on ensuring the independence and objectivity of the board and its directors. For example, an employee can no longer serve as the chair of the board or hold a position with similar responsibilities. This provision makes it illegal for one person to lead the administration of an organization and its governance. The responsibility must be divided between multiple parties who work in tandem. This minimizes collusion by separating powers. One party can provide information regarding the many facets of the nonprofit to help the board understand the situation but is unable to affect the discussion or the vote of the board's decision.

The Revitalization Act requires a nonprofit organization to have at least two types of committees: (a) committees of the board, which are made up solely of board directors, and (b) committees of the organization, which can contain a mix of directors and non-directors. Only committees of the board can bind the organization. Additionally, the Revitalization Act requires that the directors be independent and not have significant financial involvement in the organization.

The Revitalization Act also increases the threshold amounts for requiring a CPA audit. Under the Act, a nonprofit corporation with annual revenue in excess of \$500,000 must establish an audit committee composed solely of independent directors,³⁵ or, alternatively, have the independent directors of the board serve the functions of an audit committee. The audit committee or independent directors are required to oversee the accounting and financial reporting processes of the entity as well as the annual audit of the entity's financial statements,

³⁴ Non-Profit Revitalization Act, 2013 §712.

³⁵ "Independent director" is defined in Section 102(a)(21) as a Director who: (1) is not, and has not been within the last three years, an employee of the corporation or an affiliate of the corporation, and does not have a relative who is, or has been within the last three years, a key employee of the corporation or an affiliate of the corporation; (ii) has not received, and does not have a relative who has received, in any of the last three fiscal years, more than \$10,000 in direct compensation from the corporation or an affiliate of the corporation (other than reimbursement for expenses reasonably incurred as a director or reasonable compensation for service as a director as permitted by paragraph (A) of Section 202(general and special powers)); and (iii) is not a current employee of or has a substantial financial interest in, any entity that has made payments to, or received payments from, the corporation or an affiliate of the corporation for property or services in an amount which, in any of the last three fiscal years, exceeds the lesser of \$25,000 or 2% of such entity's consolidated gross revenues. For purposes of this subparagraph, "payment" does not include charitable contributions.

including by retaining an independent auditor to conduct the audit and reviewing the audit results with the auditor. These additional review requirements of the audit committee apply to corporations with annual revenue greater than \$1,000,000 in the prior fiscal year. It is worth noting that there is no requirement that all directors be considered “independent” – rather, the focus should be on ensuring that certain governance functions, such as audit oversight, are within the exclusive control of independent directors.³⁶

Additionally, the Revitalization Act relaxes certain audit-related thresholds related to financial reporting with the Attorney General for nonprofits. Corporations receiving gross revenue and support greater than \$500,000 in a fiscal year will be required to file an annual fiscal report and an audit report prepared by an independent CPA with the Attorney General.³⁷ Corporations receiving gross revenue and support greater than \$250,000 but less than \$500,000 in a fiscal year will be required to file with the Attorney General an annual financial report and a review report prepared by an independent CPA. Corporations receiving gross revenue and support less than \$250,000 in a fiscal year will be required only to file an audited financial report with the Attorney General.³⁸

These new requirements raise the threshold requirements for the filings. They benefit the organization with revenue of \$100,000 to \$250,000, because it is relieved of a review or audit done by an outside CPA. The filing requirement was burdensome to smaller nonprofits, and the increased thresholds make it easier for smaller nonprofits to comply. However, audits are a key step in avoiding mishaps. It was through an audit that the missing funds were uncovered in the case of the former financial director for a New York Chapter of the American Red Cross.³⁹ In the case of H.O.W. Foundation,⁴⁰ the former executive director wrote himself 213 unauthorized checks for a total of more than \$1.35 million and embezzled more than \$200,000 from a thrift store operated by the nonprofit over eight years.

The Revitalization Act defines an “independent director” as one who is not, and who has not been within the last three years, an employee of the corporation or an affiliate of the corporation, and who does not have a relative who is, or who has been within the last three years, a key employee of the corporation or an affiliate of the corporation.⁴¹ However, the nonprofit is given leeway by allowing the independent director to receive no more than \$10,000 as direct compensation, or a financial interest in an entity that adds up to no more than \$25,000 or 2 percent of the corporation’s gross revenue for property or services (whichever is less).⁴² The

³⁶ *Id.*

³⁷ This threshold will increase to \$750,000 in 2017 and \$1,000,000 in 2021.

³⁸ Revitalization Act Section 102.

³⁹ In 2013, the former financial director for New York Red Cross Chapter was sentenced to two to seven years in prison for grand larceny. As signatory of the chapter’s operating account, she obtained an ATM debit card in her name that was linked to the chapter’s account to make cash withdrawals, as often as every few days in some instances. She used the money to pay for clothing, her children’s tuition, and other personal expenses, embezzling over \$274,000 between 2005 and 2009.

⁴⁰ A nonprofit alcohol and drug treatment center in Tulsa, Oklahoma.

⁴¹ New York Nonprofit Revitalization Act Section 102(a)(21)(11).

⁴² New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant Changes to New York Nonprofit Corporation Law on Horizon, *Journal of Multistate Taxation and Incentives*, March/April 2014.

definition is controversial in that not only is it unique among states but it is also found nowhere else in New York nonprofit law or in IRS rules. It is similar to a question on Form 990⁴³ but the definition differs. The term affiliate means entity controlled by, in control of, or under common control with corporation. The term “control” remains undefined under the IRS Form 990 and the Revitalization Act. This is a high bar because it makes it difficult to find independent directors.

Also, “substantial financial interest” remains undefined in the Revitalization Act. The question arises as to whether this means a senior manager or someone with an ownership interest. Say, for example, that a member of the board of directors of a theater company buys a ticket to one of the group’s performances with his own money. Does he need to disclose the material facts about the ticket purchase, even though he paid the same price as the general public? In the case of a hospital board and a director whose relative is a private pay patient or has high-deductible insurance plan, does the hospital board need to pre-approve emergency medical treatment? If the related party has “substantial financial interest,” then “alternative transactions to extent available” must also be considered, but this is not defined, so it raises questions such as whether it is a de facto bidding requirement. Are a certain number of bids required? Must they be in writing? Is publicizing required? These questions remain unanswered.

Furthermore, Section 102(a)(21)(ii) of the independent director definition makes note of relatives. This is identical to the IRS definition under the Excess Benefit Doctrine.⁴⁴

Related Party Transactions

The Revitalization Act revised NPCL § 715 and increased the approval and oversight powers of the board of directors for transactions involving “related parties.”⁴⁵ It replaced a provision governing transactions of “interested directors and officers” with a new provision regarding “Related Party Transactions,” which are defined as transactions between the organization or any of its affiliates and a related party who has a financial interest in the transaction.⁴⁶ This term is now more specific. Directors and trustees may not enter into the transaction unless the transaction meets the standard “fair, reasonable and in the corporation’s best interest at the time of such determination.”⁴⁷ Further, any director, officer, or “key employee” who has an interest in a related party transaction must disclose in good faith to the board, or an authorized committee, the material facts concerning the interest.

In the evaluation process, the Board of Directors must (i) consider alternative transactions to the extent possible; (ii) approve the transaction by a majority vote of directors present at the

⁴³ Form 990 possess four questions to determine the “independent” factor: (a) Were you compensated as an officer or other employee from this or a related organization?; (b) Did you receive total compensation or other payments exceeding \$10,000 for the year from this or a related organization as an independent contractor?; (c) Did you receive, directly or indirectly, material financial benefits from this or a related organization?; (d) did you have a family member that received compensation or other material financial benefits from this or a related organization?

⁴⁴ This was in response to an amendment to IRS in the 1990s that enacted new standards for evaluating compensation, mainly in nonprofits listed as 501(c)(3) and 501(c)(4)s.

⁴⁵ “Related party” is defined in Section 102(a)(23) as (i) any director, officer, or key employee of the corporation; (ii) any relative of a director, officer, or key employee of the corporation; or (iii) any business entity in which a person described in clauses (i) or (ii) has a 35% or greater ownership stake.

⁴⁶ *Id.*

⁴⁷ NPCL Section 715(a).

meeting; and (iii) document the approval by the Board of Directors, including any discussion regarding alternative proposals. As to what extent related party transactions are intended to overlap with conflicts of interest, it remains unclear, but it appears that all related party transactions are likely potential conflicts of interest and that there may be additional conflicts of interest that are not related party transactions. This requires nonprofit boards to subject such transactions to careful scrutiny.

In the NPCL, the “financial interest” is applied to any transaction between two corporations which may have a director or officer in common but in which the director does not have a financial interest. This provision was dropped in the Revitalization Act, resulting in a possible conflict of interest. For example, a conflict that wouldn’t be covered would be two nonprofits collaborating with each other and sharing a director. This is no longer a conflict of interest on the face of the statute.

At first glance, the “key” employee section might appear to derive directly from the IRS statute. However, the IRS statute uses the term “person with substantial interest” and not “key employee.” The IRS regulation encompasses more than employees. The “ownership or beneficial interest” under Section 102(a)(23)(iii)(ii) is consistent with IRS regulations. This is addressing persons who have a significant interest in vendors with which nonprofits may be doing business.

Contrary to the SOX, the Revitalization Act does not provide a check and balances system by requiring both the board and the audit committee to review any related party transactions; rather, it gives that task to the board of directors or authorized committee. This requires scrupulous review of transactions. One result of the absence of checks and balances is the Project Genesis case.⁴⁸ On October 12, 2013, the former CFO of Project Genesis, a Connecticut nonprofit organization that served people with disabilities, was sentenced to 33 months’ imprisonment after embezzling more than \$348,000 from the organization over a three-year period. He stole such funds by keeping terminated employees on the payroll and then transferring their salaries to his personal bank account.⁴⁹

If the board of directors does not follow the prescribed procedures, the Revitalization Act authorizes the attorney general to bring action to enjoin, void, or rescind the related party transaction and to seek restitution, to remove directors and officers, or to take other remedial actions.⁵⁰ With respect to these provisions, there is no “de minimis” threshold, and in the case of willful or intentional misconduct, the attorney general is authorized to require a corporation to repay double the amount of improperly obtained benefit.⁵¹ This gives the attorney general plenty to shoot at in challenging transactions. The power to “void” a transaction may have profound consequences. It may determine how the power will be administered and how much deference a judge gives to the board of directors’ statements.

⁴⁸ FBI Press Release 2012, former CEO of Willimantic Non-Profit Admits Embezzling More than \$348,000.

⁴⁹ *Id.*

⁵⁰ Keith J. Kehrer and Chaeri K. Tornay, *New York’s Nonprofit Revitalization Act of 2013 and Its Impact on Nonprofit Organizations*, April 2, 2014.

⁵¹ *Id.*

Violation may go beyond improper benefit to include failure to approve a transaction. This contracts the IRS excess benefit rules, under which an organization can demonstrate a transaction is reasonable even if not approved in advance. The IRS rules are structured to encourage the organization to do everything upfront. If so, the IRS gives deference to that process or decision. Under the Revitalization Act, the attorney general would have the power to say that the reasonableness of the transaction does not matter, a departure from federal law.

Furthermore, prior to initial election and at least annually thereafter, each nonprofit corporation must require directors to sign and submit a written statement identifying those entities in which they have relationships as officers, directors, owners, or employees, and with which the nonprofit corporation has a relationship. This statement must also include any transaction in which the nonprofit corporation is a participant if the director may have a conflict of interest. These statements must be provided to the chair of the audit committee for review upon completion. The approval process is in parallel to the IRS “excess benefit” rules except for independent director requirement. Procedures to deal with the IRS regulations will satisfy Revitalization Act regulations.

III. Recommendations and Conclusions

Organizations in small communities might struggle with finding a sufficient number of “independent” directors to serve on the audit committee given the Act’s stringent definition. However, the limitation is balanced in the Revitalization Act’s requirement of less scrutiny of reporting by smaller nonprofits. Regulatory intent seems to be to increase the impartiality and independence of board members, resulting in less chance of collusion within the organization.

Requiring the use of an independent audit committee by the nonprofit will provide an effective way to maintain control and objectivity, thus ensuring a foundationally secure financial process that is able to detect and prevent financial mismanagement. Not specifying a number of individuals that must be on the board will give leeway for small nonprofits to leverage the board position by appointing qualified and knowledgeable individuals to oversee the financial aspect of the organization. Management and board members are often more trusting, which leads to less stringent financial controls for nonprofits.⁵² However, a belief that audits will catch any fraud is flawed. The Association of Certified Fraud Examiners reports that less than 10 percent of frauds are discovered as a result of an audit by an independent account firm.⁵³ Auditors only have a responsibility to give “reasonable” assurance that no material misstatements in financial statements have been made.⁵⁴ This is a low standard. Therefore, external audits are crucial in ensuring that effective financial controls and fraud prevention measures are being followed.

The nonprofit sector is self-regulatory. The best way to take full advantage of the Revitalization Act would be to bifurcate the nonprofit board into a board of directors-managers responsible for day-to-day management of activities and a supervisory board of advisors charged with oversight of such management board. The board of directors would owe fiduciary duties to its members and to beneficiaries but not concern itself with managing the nonprofit organization.

⁵² William H. Devaney and Jeffrey S. Tenebaum, Preventing Embezzlement and Fraud in Nonprofit Organizations, May 4, 2011.

⁵³ *Id.*

⁵⁴ *Id.*

This board could serve as the audit committee and report annually to the appropriate authorities. These advisors cannot be employees of the nonprofit, therefore obeying the Revitalization Act.

The Revitalization Act’s focus is on the independence of directors. Adopting audits and audit committees is a development out of the SOX that does not take into consideration the complexity and diversity of the charitable sector, merely the financial revenue of the organization. The SOX provided a heightened scrutiny environment for audit committees and outside auditors in the for-profit sector. It made the audit committee directly responsible. This important characteristic is now in the Revitalization Act, and the audit committee is virtually the one responsible if accounting and financial processes go wrong.

The nonprofit standards set in the Revitalization Act are tailored toward the business corporate standard as set forth in the SOX. This shift in the governance of internal matters within a nonprofit should be salutary. To be sure, applying blanket standard to the actions and responsibilities of all board members for all nonprofits may be too lenient, because it ignores the special public purpose carried by nonprofits, the nature of the nonprofit board, and the inadequacy of internal control and enforcement. This highlights the differences between the Revitalization Act and SOX. The Revitalization Act considers the size and financial revenue of the organization, which makes it easier for smaller nonprofits to comply with regulations. However, the Revitalization Act mandates that the nonprofit organizations fill the positions of board members and audit committees with individuals academically prepared for these roles rather than just the individuals with the deepest pockets, inasmuch as those who might be interested in board membership are often dissuaded out of concerns of liability.

It would be wise to add a clause protecting directors from monetary liability for unintentional fiduciary duty breaches, as with Delaware businesses and nonprofits. Such a provision may have been omitted because of the widespread scandals, but it should be reassessed.

Modeling the requirements pertaining to board of directors, audit committees, and auditors of the New York Nonprofit Revitalization Act on the Sarbanes-Oxley Act is a proactive step to reduce the risk of future scandals in the nonprofit sector. The checks-and-balances system is a step forward to ensure that fraud and corruption do not diminish public trust in nonprofit organizations. But as we see evidence of how the Revitalization Act affects the nonprofit industry, the law must continue to evolve.

Chart 1: Changes in the NPCL amendments to New York Nonprofit Revitalization Act

	NPCL Amendments	New York Non-Profit Revitalization Act (Current Law)
Governance	Requires the board of directors, board of trustees, or other governing body of a nonprofit corporation to consist of at least three individuals. There continues to be no cap on the number of directors who may serve.	Prohibits an employee of a nonprofit corporation from serving as the chair of its governing board or holding any other title with similar responsibilities.

	NPCL Amendments	New York Non-Profit Revitalization Act (Current Law)
Types of Committees	Nonprofit may have standing and special committees of the board in addition to committees of the corporation.	Nonprofit corporations may establish and maintain two types of committees: (1) a “committee of the board,” whose members must be members of the board, which may be delegated powers of the board and which can exercise authority to bind the corporation; (2) a “committee of the corporation,” which may include directors and non-directors. Also dispenses with the distinction between standing and special committees.
Related-Party Transactions	<ul style="list-style-type: none"> • Gave rise to questions as to whether any director or officer involved was fulfilling duty of loyalty to the organization; such transactions, if approved and entered into, were valid, binding, and enforceable against the organization. • Financial interest applied to any transaction between two corporations that may have a director or officer in common. 	<ul style="list-style-type: none"> • The presumption is that a related-party transaction is invalid and therefore unenforceable unless the organization’s governing body determines that the transaction is fair, reasonable, and in the best interest of the organization. A “related party” is a person who serves as a director, officer, or key employee of the nonprofit organization or any affiliate thereof, or is any such person’s relative. “Related party” also includes any entity in which any of the foregoing individuals has a 35% or greater ownership or beneficial interest, or, in the case of a partnership or professional corporation, a direct or indirect ownership interest in excess of 5%. • This provision regarding financial interests was dropped completely.
Audit-related thresholds (gross revenue)	<p>Requirements before July 1, 2014</p> <p>< \$100,000: no accountant’s report required</p> <p>\$100,000-\$250,000: independent accountant’s review report and financial statements with accompanying notes</p> <p>> \$250,000: independent accountant’s audit report and financial statements and accompanying notes.</p>	<p>Requirements through June 30, 2017</p> <p>< \$250,000: unaudited financial report</p> <p>\$250,000-\$500,000: Independent CPA review report</p> <p>> \$500,000: Independent CPA audit report</p> <p>Requirements beginning July 1, 2017</p> <p>< \$250,000: Unaudited financial report</p> <p>\$250,000-750,000: Independent CPA review report</p> <p>> \$750,000: Independent CPA review report</p> <p>Requirements beginning July 1, 2021</p> <p>< \$250,000: Unaudited financial report</p> <p>\$250,000-\$1,000,000: Independent CPA review report</p> <p>> 1,000,000: Independent CPA review report</p>

	NPCL Amendments	New York Non-Profit Revitalization Act (Current Law)
Financial Statements	Responsibility was divided between multiple board members and/or parties who had to work in tandem to achieve success	The board, or a board-designated audit committee composed only of independent directors, must oversee the accounting and financial reporting processes of the nonprofit and the auditing of financial statements. Oversight includes retaining auditors and reviewing audits, if required, on an annual basis. Attorney General can require an organization to have its financial statements audited, even if the organization's gross revenue is below the threshold limit. See audit-related thresholds below.