

ATTORNEY GENERAL'S LEGISLATIVE PROGRAM  
PROGRAM BILL # 02-03

Senate #

Assembly #

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MEMORANDUM

AN ACT to amend the not-for-profit corporation law, in relation to protections against financial fraud and abuse, and to repeal certain provisions of such law relating thereto

PURPOSE:

This bill protects against financial frauds by not-for-profit corporations by adopting reforms similar to those enacted by the federal Sarbanes-Oxley law, as well as other important protections.

SUMMARY OF PROVISIONS:

Section 1 of the bill amends section 519 of the Not-For-Profit Corporation Law ("NPCL") to provide that the president and treasurer of each not-for-profit corporation shall sign and certify to the accuracy of the corporation's annual report. If the not-for-profit entity has gross revenues over \$250,000, or if the president or treasurer receives compensation for such service, then the signing officers shall also certify to the accuracy of the financial statements, and to the sufficiency of the internal controls of the corporation.

Section 2 of the bill amends NPCL § 520 to: (a) clarify that the annual reports filed by not-for-profit corporations shall be complete and accurate; (b) provide that the persistent failure to file complete and accurate reports shall be a breach of the directors' and officers' duty to the corporation; and (c) provide that such persistent failure shall subject the directors and officers to an action for removal.

Section 3 of the bill makes technical amendments to NPCL § 521.

Section 4 of the bill amends NPCL § 712 to require that not-for-profit boards designate an executive committee and an audit committee, if permitted to do so by the articles of incorporation or the by-laws, and if the not-for-profit corporation has annual gross revenues over \$250,000. The audit committee shall be directly responsible for overseeing the work of any public accounting firm employed by the corporation. In addition, members of the audit committee may not: (a) accept any consulting, advisory, or other compensatory fee from the corporation; or (b) have participated in any interested party transactions within the previous year.

The audit committee must establish procedures for handling complaints regarding auditing matters.

Section 4 of the bill repeals NPCL § 715 and enacts a new section 715 to govern the activities of interested directors and officers. In particular:

- Subdivision (a) of new section 715 provides that, where there is a contract or transaction between the corporation and its directors or officers, or between the corporation and another entity in which one of its directors or officers has a substantial financial interest, the interested director or officer must establish that he or she acted in good faith and that the contract or transaction was fair and reasonable. Subdivision (a) further permits the voiding of such contracts or other transactions where those tests are not met.
- Subdivision (b) of new section 715 establishes a presumption of substantive fairness and reasonableness when appropriate disclosures are made and due diligence is performed.
- Subdivision (c) of new section 715 links the remedies for violation of these standards to the penalty standards already contained in analogous provisions of the Internal Revenue Code.
- Subdivision (d) of new section 715 provides that the articles of incorporation or by-laws of the not-for-profit corporation may provide additional restrictions on interested party contracts;
- Subdivisions (e) and (f) of new section 715 establish more specific standards for the approval of director and officer compensation.
- Subdivisions (g) and (h) of new section 715 include a definition of "affiliate" and provide a de minimus exception to the interested party contract standards.

Section 6 of the bill repeals NPCL § 721 and enacts a new section 721, making clear that any provision made by a corporation to indemnify its or its subsidiary's directors or officers for the defense of any proceeding must comply with NPCL Article 7.

Section 7 of the bill amends NPCL § 722: (a) to provide that the indemnification may cover costs as well as attorneys' fees; (b) to limit the scope of section 722(b) to civil actions; and (c) to make various technical amendments.

Section 8 of the bill makes conforming amendments to NPCL § 723.

Section 9 of the bill amends NPCL § 724 to add a provision requiring notice to the

Attorney General of any application to a court for indemnification of the officer or director of a type B or C corporation, and to require an undertaking as a condition to indemnification under NPCL § 725(a).

Section 10 of the bill amends NPCL § 725 to make conforming amendments.  
The bill takes effect ninety days following enactment.

#### **EXISTING LAW:**

There is no current provision requiring any officer of a not-for-profit corporation to sign the annual report, or to certify to the accuracy of the annual report, the accuracy of the financial statements, or the adequacy of the not-for-profit's internal controls. In addition, there is no current requirement that not-for-profit corporations appoint an audit committee.

NPCL § 520 requires a not-for-profit corporation to file periodic reports where required by state law, and provides that wilful failure to file shall constitute a breach of the directors' duty to the corporation.

NPCL § 715 governs the activities of interested directors and officers.

NPCL § 721 currently permits indemnification of officers and directors for expenses, including attorneys' fees, unless there is a final adjudication that the individual acted in bad faith, was deliberately dishonest, or gained an unlawful personal advantage. The section permits a not-for-profit corporation to adopt a different, inconsistent indemnification standard.

NPCL §§ 722 through 726 provide for indemnification in various legal proceedings.

#### **JUSTIFICATION:**

The recent scandals at Enron, Arthur Anderson, Global Crossing, Tyco and other major corporations clearly demonstrate the need for significant legislative reforms to protect New York residents from similar corporate abuses in the future. This bill – which is one of six bills being proposed by the Attorney General as part of the Corporate Fraud Prevention Initiative of 2003 – seeks to provide for greater protections against fraud and misconduct by the directors and officers of not-for-profit corporations.

The federal Sarbanes-Oxley law passed by Congress last year (Public Law 107-240) enacted important corporate governance reforms. For example the Sarbanes-Oxley law:

- required CEOs to certify to: (1) the accuracy of the corporation's annual reports; (2) the accuracy of the company's financial statements; and (3) the adequacy of the company's internal controls;

- required the appointment of audit committees, and required those audit committees to be responsible for overseeing the work of any public accounting firm employed by the corporation;
- provided that audit committee members could not accept any consulting fees from the corporation, and could not have participated in any interested party transactions within the previous year;
- required the establishment of procedures for handling complaints regarding auditing matters.

These protections apply only to for-profit corporations, however, and there are thousands of not-for-profit entities that control millions of dollars in charitable dollars that lack these basic protections. Indeed, while for-profit corporations have shareholders with a strong interest in ensuring the financial integrity of the corporation, there is no such shareholder oversight for not-for-profits, and thus it is even more important that these types of financial controls be placed on charitable entities. This bill accomplishes this goal by amending the NPCL to incorporate these protections from the Sarbanes-Oxley law.

In addition, the bill makes several other important changes to prevent against financial misconduct by not-for-profit entities, including:

- authorizing actions for the removal of directors and officers for the wilful or persistent failure to file accurate annual reports;
- improving the existing statutory provisions governing contracts between a not-for-profit corporation and its directors or officers, or between the corporation and another entity in which one of its directors or officers has a substantial financial interest; and
- establishing appropriate limits on the indemnification of directors and officers by a not-for-profit corporation;

Together, these changes will help to prevent against fraud, waste and abuse by not-for-profit entities, and therefore will help ensure responsible stewardship of the billions of dollars that New Yorkers contribute to charitable entities every year.

#### **LEGISLATIVE HISTORY:**

This is a new bill.

**FISCAL IMPLICATIONS:**

None.

**EFFECTIVE DATE:**

The bill takes effect ninety days after enactment.