



2022 Nonprofit Update: Legal & Governance

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CORPORATE GOVERNANCE PRIMER

- **UNDERSTANDING FIDUCIARY DUTIES OF BOARD MEMBERS**
- **TRAPS FOR THE UNWARY**

FIDUCIARY DUTIES OF NONPROFIT DIRECTORS

Fundamental Precepts:

1-Directors of Nonprofits have Legal Duties (Fiduciary Duties).

2-There can be Personal Liability to Directors for Breaching these Legal Duties.

3 Fundamental Legal Duties of a Nonprofit Director Under New York Law:

- **Duty of Care**
- **Duty of Loyalty**
- **Duty of Obedience**

Duty of Care:

- ❖ A director must discharge the duties of his/her position in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.
- NPCL § 717(a)
 - Oversight function.
 - Requires familiarity with the organization's finances and activities and regular participation in its governance.
 - ✓ **Healing Arts Initiative lawsuit (April 2016)**

Healing Arts Initiative lawsuit (April 2016)

- New York State Supreme Court, New York County
- **Defendants (Board of Directors)**
 - ✓ D. Leslie Winter
 - ✓ Alan Gettner
 - ✓ Greg Libertiny
 - ✓ Laura Anne Walker
 - ✓ Jonathan Pearlroth
 - ✓ J. David Sweeny
 - ✓ Richard Gomes
 - ✓ Hospital Audiences, Inc. a/k/a Healing Arts Initiative, Inc.

Healing Arts Initiative lawsuit (April 2016)

This is an action to hold accountable the directors of Hospital Audiences, Inc. a/k/a Healing Arts Initiative, Inc. ("HAI") who, in violation of New York Not-For-Profit Corporation Law ("N-PCL") §§ 717 and 720 and other applicable statutory or common law, have neglected, failed to perform, and/or violated their duties, including but not limited to, their duty to act in good faith and with the care of an ordinarily prudent person in a like position would exercise under similar circumstances, in the management of HAI, by permitting \$750,000 to be stolen by three former employees of HAI, hiring non-independent auditors, negligently hiring employees, and otherwise breaching their duties to HAI.

Healing Arts Initiative lawsuit (April 2016)

The foregoing actions constitute, *inter alia*, breach of contract, breach of fiduciary duty, and violations of N-PCL §§ 717 and 720. Plaintiff expressly reserves the right to amend its claims in this action to include other causes of action and other parties as may be appropriate.

PLEASE TAKE FURTHER NOTICE that the relief sought in this action is damages in an amount not less than \$750,000, believed to be foreseeably and proximately caused by Defendants' conduct referenced above, plus attorneys' fees and punitive damages, removal of the board of directors, as well as any other relief the Court deems just and proper.

Duty of Care: A Roadmap:

- ✓ **Right From The Start: Responsibilities of Directors of Not-for-Profit Corporations (Charities Bureau, 2015)**
- ✓ **The Committee to Save Adelphi, et al. v. Diamandopoulos, et al. (Board of Regents, 1997)**
- ✓ **Unsecured Creditor Trustee of Dowling College v. 13 individuals being sued in their capacity as board members (trustees) of Dowling College (and also as CFO)**
- ✓ **Internal Controls**
 - ❑ **Internal Controls And Financial Accountability For Not-For-Profit Boards (Charities Bureau, 2015)**
- ✓ **Policies & Procedures**
- ✓ **Critical Role of Audit Oversight (Independence Requirement)**
 - ❑ **Audit Committee Requirements And Responsibilities Under New York's Not-For-Profit Corporation Law As Amended Through 2017 (Charities Bureau, 2018)**

Duty of Loyalty:

- ❖ A director must act in the interest of the organization.
 - Requires undivided allegiance to the organization's mission when using the power of his/her position, or information concerning the organization or its property.
 - Conflicts of interest; related party transactions.

Duty of Obedience:

- ❖ Least understood and most often neglected of the 3 primary legal duties
- ❖ Why? The other 2 primary legal duties exist in the for-profit world, but the Duty of Obedience is strictly a not-for-profit law concept

What is the Duty of Obedience?

- ❖ to ensure that the organization complies with applicable laws and regulations and its internal governance documents and policies
 - Compliance with applicable laws and regulations is even more difficult than it sounds
 - Multiple layers of laws and regulations

Duty of Obedience - Compliance with Laws and Regulations :

- **Not-for-Profit Corporation Law**
- **Laws & Regulations – additional layers**

Not-for-Profit Corporation Law:

- **Best efforts under difficult circumstances is not the compliance standard**
- **Law**
- **Mandatory requirements & procedures**
- **Bright lines**
- **Rigid**
- **Inflexible (cemetery pandemic example)**
- **Unforgiving**

Duty of Obedience - Compliance with Internal Governance Documents and Policies:

- Certificate of Incorporation
- Bylaws

A Trap for the Unwary

Duty of Obedience - Compliance with Certificate of Incorporation

- Corporate Purposes are set forth in the Certificate of Incorporation
 - ✓ *A diversion from corporate purposes no matter how worthy is a breach of fiduciary duty.*
 - ✓ *One of the central oversight functions of directors and officers: use of assets consistent with the purposes in the Certificate of Incorporation.*

A Trap for the Unwary

continued

- Phone call during the height of the pandemic from an accountant who had a nonprofit client that had started a wonderful new program in response to the pandemic. The program addressed food insecurity and food needs in the community.
- One problem. This activity, though vitally important, fell outside of the purposes set forth in the Certificate of Incorporation.

A Trap for the Unwary *continued*

- ✓ *A diversion from corporate purposes no matter how worthy is a breach of fiduciary duty.*
- ✓ **Potential Personal Liability of Board Members for failure to strictly adhere to corporate purposes**

continued . . .

More Traps for the Unwary

- **Phone call during the height of the pandemic from a concerned board member (the nonprofit is not a client);**
- **board chair had asked the board to vote by email on nominations;**
- **chair states in an email to the board that, while normally the board would have a meeting to vote on nominations, because of the pandemic, the board would vote by email instead**

continued . . .

More Traps for the Unwary

continued

Email voting by the board of directors – another impermissible shortcut to avoid

- ✓ There are only 2 ways for the board to act under the law:
 1. At a meeting (which can be in person; by conference call; or by videoconference);
 2. By unanimous consent in lieu of a meeting (which can be email or written)
 - Must be unanimous (≠ voting)

- ✓ Effect of missteps

DOCUMENTING CORPORATE ACTION & COMPLIANCE

No dispensation for extraordinary circumstances

Minutes, Minutes, Minutes

- Too much detail

- Too little detail

- Checklist to demonstrate that the board fulfilled its fiduciary duties

Conflicts & Related Party Transactions (annual + ongoing)

Effect of missteps

GOVERNANCE: IT'S NOT ROCKET SCIENCE!

- ✓ Process, Process, Process
- ✓ Procedures
- ✓ Mandatory Requirements
- ✓ Board Education
- ✓ Awareness – Even Under Extraordinary Circumstances
- ✓ Discipline & Commitment to Compliance

CENTRAL ROLE OF BYLAWS

- Bylaws: contract between the organization, the board, and the members as to how the organization will operate
- Bylaws are rules by which legitimate corporate decisions are made
- *Following these rules is a roadmap to protect directors from breach of fiduciary duty allegations*

- ✓ *Always follow the roadmap that the Bylaws provide!*
- ✓ *Make sure that the Bylaws are consistent with the Not-for-Profit Corporation Law of the State of New York!*
- ✓ *Failure to strictly adhere to requirements of the Bylaws, or having Bylaws that are inconsistent with the law, is a **breach of the Duty of Obedience.** Consequences can include undermining the validity of corporate decisions and actions.*
- ✓ ***Governance mistakes in these areas are another potential trap for nonprofit directors & officers***

Risks of governance mistakes in these areas:

- **Board decisions can be challenged as illegitimate**
- **Breach of duty & personal liability**

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Another Trap for the Unwary

COMMITTEES

➤ Board Committees

Typical Examples: Executive; Audit; Nominating; Governance; Development; Compensation

- At least 3 directors
- Only board members can vote

➤ **Committees of the Corporation**

- Misnomer
- **Advisory only**

Who is on the committee

Description of responsibilities:

✓ Charter, board resolution or Bylaws

ADEQUATE OVERSIGHT

- Adequate Oversight \neq trust
- Volunteers doing good
- Smart and accomplished board
 - ✓ Dowling; Adelphi

Ostrich defense/Sergeant Schultz
defense will not work under NY
NPCL

Oversight:

- Audit Committee
- Audit Process
- Auditor

Another Trap for the Unwary: OVERKILL

- Provisions that are too demanding -- examples
 - ✓ Bylaws: frequency of meetings; quorum; responsibilities of officers &/or committees; Audit Committee; not taking advantage of NPCL amendments
 - ✓ Conflicts Policy: application too broad in terms of covered persons

Another Trap for the Unwary

FILE CABINET SYNDROME

- Develop, review, approve & file away
 - ✓ Live with these documents & procedures
 - ✓ Know them
 - ✓ Follow them (continuous commitment & focus)

More Traps

➤ NPCL TRAP

(Examples: supermajority requirement for officer compensation; executive committee; supermajority quorum for removal; member notice; notice requirements for dissolution)

➤ PROCESS TRAP

(Required filings; amend purposes; mission statement in Bylaws)

PRIMACY OF THE IRS FORM 990

TRAPS FOR THE UNWARY

IRS Form 990 Signature Block:

- **Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.**

Part VI, Governance, Management and Disclosure

Section A. Governing Body and Management

➤ Independence

➤ Relationships (family or business)

➤ Members

✓ Do members have power to elect the governing body?

✓ Any governance decisions reserved to members or subject to member approval?

➤ Minutes

- ✓ Board

- ✓ Committee

➤ Did the organization become aware during the year of a significant diversion of the organization's assets?

Part VI, Governance, Management and Disclosure

Section B. Policies

“(Section B requests information about policies not required by the Internal Revenue Code.)”

➤ **Governance Body Scan**

- Line 11(a): Has the organization provided a complete copy of this Form 990 to all members of its governing body before filing the form?
- Line 11(b): Describe in Schedule O the process, if any, used by the organization to review this Form 990.
- Line 12: **Conflict of Interest Policy**
 - ❖ State law implications
- Line 13: Whistleblower Policy
- Line 14: Document Retention & Destruction Policy

- Line 15: Process for Determining Compensation
 - ✓ CEO, Executive Director, or top management official; other officers or key employees

- Line 16: Did the organization invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity?
 - ✓ If “Yes,” did the organization follow a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable federal tax law, and take steps to safeguard the organization’s exempt status with respect to such arrangements?

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More Traps for the Unwary

Annual Financial Report:

- Mandated by §519 and §513 of the N-PCL
- Specific information required by law

Annual Financial Report Timing Trap

- The annual financial report requirement mandates that the financial information presented be for a twelve-month fiscal period terminating not more than six months prior to the meeting
- So, if your fiscal year is the calendar year, then for your financial information not to be stale, you need to have your annual meeting, and present the annual financial report, before the end of June

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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF NEW YORK

(May 13, 2019)

DOWLING COLLEGE

Plaintiff:

Unsecured Creditor Trustee of
Dowling College

Defendants:

13 individuals being sued in their capacity as Board members (trustees) of
Dowling College (and also as CFO)

Complaint

Trustees Responsibilities:

- ❑ responsibility to ensure that Dowling's business was carefully managed
- ❑ responsible for devising, maintaining, and implementing proper controls with respect to Dowling's business, operations, and financial affairs, including internal financial controls and operating procedures
- ❑ responsibility to ensure business, as conducted by its employees and representatives, including day-to-day management, complied with all laws applicable to Dowling's industry and to lawful business in general
- ❑ responsible to ensure and to oversee the establishment, implementation, and maintenance of Dowling's internal financial controls and operating procedures

“It is abundantly clear from Dowling’s **Board minutes** and other documents that Dowling’s management

did not have any coherent plan

- to manage its failing enrollment (and resultant financial decline),
- to bolster its failed fundraising,
- or to pay its enormous Bond debt of \$57 million.”

Ostrich defense/Sergeant
Schultz defense will not work
under NY NPCL.

- ❑ Software used to manage financial data was not properly updated, and the resultant data was incomplete and unreliable.
- ❑ Dowling did not have any reliable report to assess departmental and academic program financial results, and had an insufficient chart of accounts that did not enable Dowling to adequately conduct its financial reporting and analysis.
- ❑ Consequently, Dowling's Board and Dowling's administration did not have the proper tools to evaluate Dowling's financial position or to make informed decisions.

Complaint alleges:

- Dowling's financial reporting under defendants' Board participation was woefully inadequate.
- Dowling's data management system did not provide reliable or accurate information from which defendants could make informed business and financial decisions.
- Defendants knew that the data management system data and financial information was unreliable and, rather than remedy the situation, used such unreliable information to Dowling's detriment.
- There were glaring deficiencies in financial reporting.

- ❑ Defendant Board members and CFO owed a **fiduciary duty** to Dowling, and had a duty to Dowling and to its creditors to **carefully manage Dowling's business operations, and to devise, implement and maintain proper controls** with respect to Dowling's business, operations, and financial affairs.
- ❑ Defendants **neglected and failed to perform their duties in overseeing the management** and disposition of Dowling's assets committed to their charge, and thereby wasted, mismanaged, and recklessly and negligently dissipated such corporate assets.
- ❑ As a **result** of all of the foregoing **misconduct** by defendants, Dowling suffered losses totaling at least **\$50,000,000, leaving Dowling with liabilities substantially in excess of its assets, which culminated in Dowling's financial ruin and ultimate bankruptcy.**

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