2023 Nonprofit Update: Legal & Governance

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Certilman Balin Adler & Hyman, LLP

Nonprofit/Tax Exempt/Religious Organizations Practice Group

David Goldstein, Esq.

(516) 296-7811; dgoldstein@certilmanbalin.com

NONPROFIT GOVERNANCE:
COMMON MISSTEPS TO AVOID

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 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

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 (Misstep)**
- **Law**
- **Mandatory requirements & procedures**
- **Bright lines**
- **Rigid**
- **Inflexible**
- **Unforgiving**

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

- Certificate of Incorporation (Purposes)
- Bylaws
- Policies
- Committee Charters

Common Missteps

- ✓ Conflicts of Interest & Related Party Transactions
  - ❑ Before Joining the Board + Annual
  - ❑ Ongoing
  - ❑ Mandatory Procedures
  - ❑ Magic words
- ✓ Investment Policy
  - ❑ NYPMIFA
  - ❑ Mandatory Procedures (factors; minutes)

Common Missteps

- ✓ File Cabinet Syndrome
- ✓ IRS Form 990
- ✓ Bylaws Trap
  - ❑ Too easy to amend
  - ❑ Be careful not to create additional unnecessary fiduciary duties
- ✓ NPCL Conflict Policy: directors, officers, key persons

Common Missteps

- ✓ Annual Meeting
  - ❑ Elect Directors
  - ❑ Annual Report
  - ❑ Notice
- ✓ Audit Oversight
  - ❑ NPCL §712-a (mandatory provisions)
  - ❑ Audit Committee or Board (independent directors)

Common Missteps

- ✓ Email Voting
  - ❑ 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**
- ✓ Board Committees vs. Committees of the Corporation
- ✓ NPCL Trap (executive committee; supermajority quorum for removal; member notice)

Common Missteps

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.*

GOVERNANCE:
IT’S NOT ROCKET SCIENCE!

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

Risks of governance mistakes in these areas:

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

GOVERNANCE: IT'S NOT ROCKET SCIENCE!

ADEQUATE OVERSIGHT

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

<u>Ostrich defense/Sergeant Schultz defense will not work under NY NPCL</u>

Significant Litigations:

- Dowling College
- NRA
- Lutheran Care Network

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.**

The Lutheran Care Network Appellate Division Decision

DISPARATE CORPORATE PURPOSES

- The AG is seeking to enjoin "TLCN from exercising operational control over any affiliate in a manner **inconsistent with the purposes** of the affiliate or in violation of law."

- The Appellate Division Decision is "guided by the principle that, inasmuch as Coburg is an independent corporation, TLCN may not operate Coburg **in a manner inconsistent with Coburg's purpose**, nor engage in **related party transactions** without complying with the relevant provisions of the Not-For-Profit Corporation Law."

From the Appellate Division Decision:

Coburg's certificate of incorporation states that Coburg's purpose is "to meet special housing needs of elderly persons and to serve the special physical needs which commonly attend advanced age . . . by planning, developing, organizing, constructing, acquiring, altering, reconstructing, rehabilitating, owning, operating and maintaining safe, sanitary, independent living facilities."

Observations:

- ***THESE ARE VERY SPECIFIC CORPORATE PURPOSES***
  - The use of corporate resources & assets is limited by and to these very specific corporate purposes
  - Transferring assets to & for the benefit of affiliates with different corporate purposes will not work – regardless of the level of affiliation & regardless of the worthiness of the ultimate nonprofit activity

Observations:

- ✓ ***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 must be consistent with the purposes set forth in the Certificate of Incorporation.***

Related Party Transactions

Appellate Division Opinion:

- TLCN may not engage in **related party transactions** without complying with the relevant provisions of the Not-For-Profit Corporation Law.

Note: The NPCL (§ 715-a) contains a mandate that the Board of Directors adopt, & oversee the implementation of, & compliance with, a Conflict of Interest Policy.

The NPCL requires that the Conflict of Interest Policy contain specific rigorous procedural & substantive requirements, including in connection with any **related party transactions** (§ 715; § 715-a).

GOVERNANCE: IT'S NOT ROCKET SCIENCE!

NY AG files Complaint against NRA & Individual Defendants

Audit Committee:

- The only committee with an entire section of the NPCL dedicated to it (§ 712-a; Audit Oversight).
- The Audit Committee is a central component of the governance structure under the NPCL.
- NRA: Epic failure of the Audit Committee

“The Audit Committee failed to perform its statutory, bylaw, and charter responsibilities as set forth in the preceding paragraphs. **As a result**, the Board was unable to exercise its responsibilities to maintain a system that was reasonably effective in identifying violations of law. In turn, **the Board displayed a sustained and systematic failure to exercise their oversight function and stood by as various laws were violated by the NRA**, including

- violations of the NRA's tax exempt status,
- false reporting on annual filings with the IRS and the Attorney General's Charities Bureau,
- improper expense documentation,
- improper wage reporting,
- improper income tax withholding,
- failure to make required excise tax reporting and payment,
- payments in excess of reasonable compensation to disqualified persons,
- and waste of NRA assets.” (¶ 531)

In some critical respects, the NRA lacked appropriate policies and internal controls. But in others, the **policies and controls were present on paper, but ignored in practice**.

A prime example was that the NRA had controls and a process in place for entering into significant contracts, which – if followed – could have prevented many of the missteps. These controls and policies were ignored – with disastrous consequences.

"The culture of noncompliance and disregard for the internal controls was evident within the NRA Audit Committee, which similarly failed to fulfill its obligation to oversee internal controls. This lack of oversight resulted in waste and loss of the NRA's charitable assets and contributed to the NRA reaching its currently deteriorated financial state." (¶ 476)

GOVERNANCE:
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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: **<u>Conflict of Interest Policy</u>**

  - 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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