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NEW YORK STATE ATTORNEY GENERAL PROPOSES ADDING CERTAIN SARBANES-OXLEY PROVISIONS TO NEW YORK NOT-FOR-PROFIT CORPORATION LAW

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On July 20, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, a sweeping package of reforms intended to promote accountability and transparency in governance of publicly-traded companies. The passage of the Act, along with related regulatory developments, has heightened attention to corporate governance in both the for-profit and not-for-profit sectors, particularly in the areas of financial management and disclosure.

New York State Attorney General Eliot Spitzer has proposed amendments to the New York Not-for-Profit Corporation Law (the "N-PCL") that would, among other things, apply certain provisions of the Sarbanes-Oxley Act to not-for-profit corporations incorporated in or doing business in New York. It is not clear whether the proposed legislation will be enacted. Directors and officers of not-for-profit corporations may be especially interested in the proposed legislation.

The following is a summary of four major proposals.

I. CERTIFICATION OF ANNUAL REPORTS

The proposed legislation would require the president and treasurer of a not-for-profit corporation to provide certifications to the annual report that are essentially identical to the certifications required of publicly-traded companies under the Sarbanes-Oxley Act.

- **"First-tier certification."** The president and treasurer of a not-for-profit corporation that receives $250,000 or less in annual "gross revenue and support" would be required to sign the corporation's annual report, certifying that (1) the signing officer has reviewed the report and (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit a material fact necessary in order to make the statements made not misleading.

- **"Second-tier certification."** The president and treasurer of a not-for-profit corporation that receives over $250,000 in annual gross revenue and support, or any president or

treasurer of a corporation who is compensated, would be required to sign the corporation's annual report. Each officer's signature would certify the two statements above, as well as (among other things) that the financial information in the report fairly presents the financial condition of the corporation in all material respects, that the signing officers have designed and maintained the corporation's internal financial controls and have evaluated their effectiveness within 90 days prior to the report, that the signing officers have disclosed to the corporation's audit committee any significant deficiencies in the internal controls and any fraud involving employees who have a significant role in the internal controls, and that the signing officers have indicated in the report whether or not there were significant changes in internal controls after the date of their evaluation, including any corrective actions regarding significant deficiencies and material weaknesses.

II. ESTABLISHMENT OF EXECUTIVE AND AUDIT COMMITTEES

- Current law permits but does not require a board to designate an executive or other standing committees. The proposed legislation would require any not-for-profit corporation that receives over $250,000 in annual gross revenue and support to designate an executive committee and an audit committee. There is an exception for corporations whose governing documents prohibit these committees, in which case the full board would act as the executive and audit committees.

- To serve on the audit committee, a director could not accept any consulting, advisory or other compensatory fee from the corporation, other than in his or her capacity as a member of the audit committee, the board, or any other board committee. Furthermore, no person could serve on the audit committee if he or she participated in any "interested party transactions" with the corporation (e.g., sale of goods or services) within the previous year.

- The proposed legislation would require the audit committee to establish procedures for the submission of complaints and concerns regarding financial matters.

III. INDEMNIFICATION

- Current law was amended in 1987 to allow a corporation's by-laws, charter or agreements to confer rights of indemnification on directors and officers beyond what is provided for in the statute, so long as the director's or officer's conduct does not violate public policy considerations. The proposed legislation would reverse the 1987 amendment by limiting the scope of indemnification of directors and officers to conduct for which the statute authorizes indemnification. Thus, indemnification and advancement of expenses could be provided only for conduct that a director or officer "reasonably believed to be in … the best interests of the corporation" or, in certain circumstances, "reasonably believed to be … not opposed to … the best interests of the corporation."

- Current law mandates indemnification where the director's or officer's conduct satisfies the "best interests" standards discussed above. The proposal would limit mandatory indemnification to circumstances in which the director or officer successfully defended the action. In the absence of mandatory indemnification, the board or a court could choose to award indemnification to the extent authorized by the statute.

- The proposal would also add notice to the Attorney General where directors or officers seek indemnification.

IV. INTERESTED DIRECTOR TRANSACTIONS/COMPENSATION OF DIRECTORS AND OFFICERS

- The proposed legislation would replace the current procedures that apply to (i) transactions between a corporation and any director or officer (or any entity in which he or she is a director or officer or has a substantial financial interest) and (ii) compensation of directors and officers.

- The proposed legislation sets forth procedures (and penalties for violation) that seek to track the so-called "intermediate sanctions" of the Internal Revenue Code (an excise tax that the IRS can impose when there are "excess benefit transactions" between public charities and their directors and officers). The proposal would require the director or officer who engaged in a transaction with the corporation (or whose affiliated entity engaged in the transaction) to establish affirmatively that he or she acted in good faith and that the contract or transaction is fair and reasonable to the corporation. Under current law, a director or officer must establish that the transaction is fair and reasonable only if the director's or officer's interest is not disclosed to or known by the board, or if the vote of the director or officer is necessary to authorize the transaction.

- The proposal would also require that the compensation of directors and officers be fixed by an affirmative vote of a majority of the *entire board*,[1] unless there is a higher standard required by the articles of incorporation or by-laws. Current law permits the by-laws of a not-for-profit corporation to provide for an alternative method of approving the compensation of officers, such as by a committee. Thus, the proposal would require this approval to be made by the full board only.

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We will continue to monitor the progress of this proposed legislation. If you have any questions or would like further information, please feel free to contact Victoria B. Bjorklund (212-455-2875, vbjorklund@stblaw.com), David A. Shevlin (212-455-3682, dshevlin@stblaw.com),

[1] The "entire board" means the total number of directors entitled to vote which the corporation would have if there were no vacancies.

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