OPERATING THE NEW YORK

NOT-FOR-PROFIT ORGANIZATION:

HOW TO MAKE STRUCTURAL CHANGES

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1. Introduction

    1. The Not-for-Profit Corporation Law ("N-PCL") provisions governing structural and operational changes made by New York not-for-profit organizations reflect the law's treatment of nonprofit assets generally. See Bjorklund, Fishman and Kurtz, New York Nonprofit Law and Practice (1997)("New York Nonprofit Law"), Section 8-1. While the particular requirements for achieving each type of change will vary, there are three common elements.

        1. The change is typically approved by the board of directors and, in the case of a membership organization, by the members.

        2. In addition, fundamental changes by charitable not-for-profit organizations also require judicial approval on notice to the Attorney General. This requirement is based on the notion that, consistent with the public purposes which not-for-profit organizations serve, the real "owner" of the organization, viz., a representative of the public interest, must approve the change.

        3. The doctrine of quasi cy pres often applies to the question of whether the proposed change is appropriate. This doctrine is applied because the organization's assets are considered to be held in trust for the purposes for which the organization was formed and operated. As discussed below, any fundamental changes in the organization's operations must bear a close relationship to the original tax exempt purpose . Id.

    2. The doctrine of quasi cy pres plays a critical role in the process of making fundamental changes in a not-for-profit organization's structure or operations.

        1. The doctrine of quasi cy pres is a variant of the common law doctrine of cy pres. Pursuant to this common law doctrine (which means "as near as possible" in archaic Anglo-French), a court will have the power to modify a charitable gift if a showing is made that, in light of changed circumstances, administration of the gift in a manner consistent with its original purpose will be impossible or impracticable. In that event, the court may modify the gift to effectuate its general charitable intent,

adhering as closely as possible to the original purpose..St. Joseph's Hospital v. Bennett, 281 N.Y. 115 (1939) (cy pres doctrine applies to gifts to charitable corporations). See also EPTL § 8-1.1, codifying the common law doctrine, with respect to charitable trusts.

2. The N-PCL codification of the cy pres doctrine in the corporate context resulted in the less restrictive quasi cy pres standard. New York Nonprofit Law, Section 8-1(a). Rather than requiring that the assets be used for the purpose for which the assets were initially held, the N-PCL allows the assets of the not-for-profit organization to be used for "substantially similar" activities. See, e.g., N-PCL § 1005(a)(3)(A) (governing assets of dissolving organizations).

3. In Alco Gravure, Inc. V. Knapp Foundation, 64 N.Y. 2d 458, 490 N.Y.S.2d 116 (1985), the New York Court of Appeals held that the quasi cy pres standard would be applied to any change in the manner of administration of not-for-profit assets, citing the provisions of the N-PCL addressing restricted gifts and dissolution. Because the Court viewed the corporate change at issue in the proceeding before it -- an amendment of the purposes clause of the organization's certificate of incorporation -- as a surreptitious method of dissolving the corporation, it applied the standard to the amendment of the corporation's purposes.

4. In re Multiple Sclerosis Service Organization of New York, 68 N.Y.2d 861, 505 N.Y.S.2d 841 (1986) clarified the issue of how the quasi cy pres standard was to be applied. In that case, the Court of Appeals indicated that the activities of the corporation, not the purposes of the organization as expressed in its certificate of incorporation, were the starting point of the analysis. It stressed that the parameters of this standard were broader than the traditional cy pres standard, and that substantial deference should be accorded to the disposition of the assets proposed by the board of directors in determining whether the proposed disposition met the standard.

2. Amendment of Certificate of Incorporation

1. If a not-for-profit corporation has a broadly drafted certificate of incorporation, most changes in governance structure, program, and manner of operation may be accomplished by an amendment of the bylaws, at most. However, where the certificate contains a great deal of detail and/or a very specific "purposes" clause, amendment of the certificate may be necessary.

2. A not-for-profit corporation has the right to amend its certificate of incorporation as often as it wishes, provided that the amendment contains only such provisions

as might be lawful in an original certificate of incorporation. N-PCL § 801.

1. Among the aspects of the certificate that may be amended are the name, purposes, duration, corporate powers, location of corporate offices, rights and powers of directors, members, and officers, and the authority to issue capital certificates.

2. A certificate of amendment does not replace the corporation's certificate of incorporation: the date of incorporation of a not-for-profit whose certificate has been amended remains the date of initial incorporation.

3. The amendment must be authorized by the governing body of the organization.

   1. In the case of an organization with no members, the amendment must be approved by a majority of the board of directors. N-PCL § 802(a).

   2. In the case of a membership organization, amendment other than those specified in § 802(c) must be approved by a majority of the members. Id..

   3. Amendments of "house-keeping" provisions in the certificate of a membership organization may be approved by the board alone. N-PCL § 802(c). These include changing the location of the office of the corporation and changing the designation or address of the registered agent. Alternatively, these changes may be made by filing a certificate of change. N-PCL § 803-A.

4. The typical amendment of a certificate of incorporation is accomplished by filing a certificate of amendment with the Secretary of State and paying a filing fee of $30.00. N-PCL § § 803, 104-A(f).

   1. The certificate must be signed and verified in accordance with N-PCL § 104(d).

   2. The certificate of amendment must contain certain provisions set forth in N-PCL § 803.

5. Particular types of amendments, however, require governmental approval.

   1. A certificate of amendment that adds, changes, or eliminates a purpose, power, or provision which required governmental approval at the time of incorporation must be approved or consented to by that governmental body at the time of amendment. N-PCL 804(a)(i).

   2. The certificate of amendment of a Type B or C corporation that seeks to

change or eliminate a purpose or power enumerate in the corporation's certificate or to add a power or purpose not enumerated in the certificate of incorporation must be approved by a justice of the Supreme Court on notice to the Attorney General. N-PCL 804(a)(ii).

1. As explained in Alco Gravure, Inc. v. Knapp Foundation, discussed at Section I above, the purpose of court approval is to assure that funds raised for an organization's initial purposes remain dedicated to those purposes, or otherwise expended consistent with the provisions of the quasi cy pres doctrine.

2. As a practical matter, a charitable not-for-profit which amends its purposes will generally be allowed to expend monies raised after approval of the amendment on the amended purposes, but it will not be authorized to expend monies raised for its initial purposes on its amended purposes.

3. Merger and Consolidation of Not-for-Profit Corporations

    1. Both mergers and consolidations involve the combination of two or more not-for-profit corporations. In general, the same rules govern mergers and consolidations.

        1. In a merger, one of the constituent corporations is the surviving entity. N-PCL § 910(a)(1).

        2. In a consolidation, on the other hand, two or more not-for-profit corporations combine to create a new entity. N-PCL § 901(a)(2).

    2. Procedural aspects of merger and consolidation.

        1. The board of each corporation must adopt a plan of merger or consolidation which states the terms and conditions of the combination and contains the other provisions required by N-PCL § 902(a).

        2. If any of the combining organizations are membership organizations, the plan must be submitted to the members for approval.

            1. Notice of the meeting at which the plan will be considered must be given to each member, whether or not that member is entitled to vote. N-PCL § 903(a)(1)

            2. The plan must be approved by a 2/3 vote of the members.

    3. Approval of mergers and consolidations.

    1. Consistent with the procedures for other structural changes, if the merged or consolidated organization which will result is one that would have required the approval or consent of any governmental body under Section 404 of the N-PCL, the merger or consolidation will require approval of that governmental body.

    2. When the two organizations which are combining are Type B or C organizations, the change must be approved by the Supreme Court on notice to the Attorney General.

        1. As discussed above, the merger or consolidation will be approved if it is demonstrated that "the interests of the constituent corporations and the public interest will not be adversely affected by the merger or consolidation." N-PCL § 907(e).

        2. The Attorney General and the Court will also review the internal approval process to assure that appropriate notice and other procedural safeguards are observed.

4. Upon the filing of the certificate of merger or consolidation or upon the date specified in the certificate (within 30 days of filing the certificate), the merger or consolidation becomes effective. N-PCL § 905(a).

4. Disposition of All or Substantially All Assets.

    1. Section 510 and 511 of the N-PCL require that certain procedures be followed and approvals be obtained before a not-for-profit corporation disposes of all or substantially all of its assets.

        1. Determination of what constitutes "substantially all" of the assets is sometimes difficult. The N-PCL does not define this term, but the legislative history indicates that it was intended to mean "not a majority of assets... but so large a proportion as to be nearly all the assets and so large that the character of the corporation's activities will necessarily be changed as a result..." Explanatory Memorandum of the Joint Legislative Commission accompanying L.1972, c.961, § 5, quoted in <u>New York Nonprofit Law</u>, p. 240.

        2. On the other hand, the Attorney General's office has generally taken the position that a sale of more than 50% of the assets would require court approval pursuant to N-PCL § 511.

    2. Approval of substantial sales, as in other significant corporate events, must be by

2/3 of the members of the organization or, if it is a non-membership organization, by 2/3 of the board of directors. The members and/or the board must approve a resolution which specifies the terms and conditions of the proposed transaction. N-PCL § 510.

3. In the case of a charitable or public benefit organization (Type B or C not-for-profit corporations), a disposition of all or substantially all of the organization's assets must be approved by a justice of the Supreme Court on notice to the Attorney General. N-PCL § 511.The required elements of a petition for approval of the disposition are set forth in N-PCL § 511. In determining whether to approve the transaction, the Court and the Attorney General will consider two major factors.

    1. First, the organization must demonstrate that the disposition will promote the interests of the members and the purposes of the corporation.

        1. In the case of an organization which intends to keep operating for an indefinite period after the transaction, it will need to show that the programs of organization will be operated more effectively because of the disposition or that the disposition will otherwise further the purposes of the organization.

        2. If, as is sometimes the case, the disposition is part of the process of dissolving the organization, the petition must contain a showing that the disposition will indirectly preserve the charitable mission, perhaps by allowing another organization to carry on work similar to that performed by the organization.

    2. Second, the organization must show that the financial terms of the sale or other disposition are fair and reasonable to the organization. Most commonly, this will involve demonstrating that the terms of the proposed disposition are at fair market value. Where an outright sale is involved, it will generally be necessary to submit a professional and independent appraisal.

5. Dissolution of a New York Not-for-Profit Corporation

    1. Dissolution is the procedure mandated under the N-PCL for terminating the corporate existence of a New York not-for-profit. Although the procedure is a complicated one, it is the most advantageous course for an organization which faces a lack of funding, staffing, or motivation to continue to pursue the organization's mission.

    2. Most not-for-profit organizations dissolve pursuant to the "non-judicial

dissolution" procedures set out in Article 10 of the N-PCL.

1. First, the board of directors must adopt a plan for the dissolution of the corporation and the distribution of its assets. N-PCL § 1001(a). If the corporation has voting members, the plan must be approved by 2/3 of the members. N-PCL § 1002(a)

2. All not-for-profits must obtain the consent of the State Tax Commission in order to dissolve. N-PCL § 1004.

3. Not-for-profit organizations whose incorporation was required to be approved by a government agency must obtain the approval of that agency to dissolve. N-PCL § 1002(c). Thus, a not-for-profit school, chartered by the New York Board of Regents, would be required to obtain the consent of the Board of Regents in order to dissolve.

4. Type B or Type C not-for-profit organizations, as well as any corporations holding assets to be used for a specific purpose, must obtain approval of the plan of dissolution from the Supreme Court on notice to the Attorney General's office. Type B or Type C organizations which have no assets to distribute, however, need not obtain approval of the plan itself. N-PCL § 1002(d).

3. In certain situations, dissolution of a not-for-profit organization will be initiated by court petition rather than by a plan of dissolution. This procedure, known as judicial dissolution, is governed by Title 11 of the N-PCL.

    1. If the organization is insolvent or dissolution will be beneficial to the members, the majority of directors or members may petition for judicial dissolution. N-PCL § 1102(a)(1).

    2. If the directors or members are so divided respecting the management of the corporation's affairs that the organization cannot be effectively governed, 10% of the members or any director may petition for dissolution. N-PCL § 1102(a)(2).

    3. In any judicial dissolution proceeding, the Attorney General is a necessary party. N-PCL 1102(b). In addition, the Attorney General has authority to commence an action to force the involuntary judicial dissolution of a corporation. The Attorney General must show that the corporation procured its formation through fraudulent misrepresentation or concealment of a material fact, exceeded its lawful authority to act, or engaged in persistent fraud and illegality. N-PCL § 1001.

4. Application of the Quasi Cy Pres Doctrine. In supervising the dissolution of Type B and Type C corporations, as well as the disposition of any restricted gifts held by a dissolving organization, the Attorney General and the Supreme Court must apply the doctrine of quasi cy pres to assure that any assets remaining after the payment of debts be distributed to organizations with "substantially similar activities." N-PCL 1005(a)(3)(A).

    1. In re Multiple Sclerosis Service Organization, discussed above in Section I, the Court of Appeals distinguished the quasi cy pres standard from the more restrictive common law standard. It also defined the factors to be considered in evaluating whether a proposed distribution of a dissolving organization's assets met the quasi cy pres standard.

        1. The source of the assets to which the doctrine is to be applied was held to be an important consideration in assessing the disposition of an organization's funds. The Court found expressions of donative intent in gift instruments or representations made by the organization in requests for funds to be significant in determining the appropriate recipients of the funds.

        2. The corporation's powers and purposes, as expressed in its certificate of incorporation, are critical factors, especially since funds donated without restrictions or specific representations as to use will be considered to be donated for the organization's general corporate purposes.

        3. The actual activities and charitable programs of the organization are of paramount importance, in view of the statutory language requiring distribution to organizations with substantially similar activities to the dissolving organization.

        4. Similarly, the relationship of the activities and purposes of the proposed distributees to those of the dissolving corporation must be carefully considered in determining whether the quasi cy pres standard has been met.

        5. The recommendation of the governing board of the organization and the reasons for that recommendation, as discussed above, should be given substantial deference, given the emphasis in the N-PCL on the critical importance of board management of not-for-profit corporations, both with respect to dissolution and in general.

    2. This quasi cy pres doctrine is consistent with the federal tax law requiring that, upon dissolution of a 501(c)(3) organization, all assets be transferred

to another 501(c)(3) organization. Indeed, certificates of incorporation of tax exempt organizations must include a provision restricting the distribution of assets upon dissolution.

5. Effectuating the Distribution of Assets and Dissolution

   1. Once the plan of dissolution is authorized (and, where approval is required, approved) and all assets have been distributed in accordance with the plan, the organization must file a financial report (generally the Form 990) showing a "zero balance" with the Attorney General's Charities Bureau. This requirement is imposed administratively by the Attorney General's office and is not specifically mandated by the N-PCL.

   2. Thereafter, a certificate of dissolution may be filed with the Secretary of State. In the case of a Type B or Type C organization, or an organization holding restricted assets, the filing of the certificate must be approved by the Supreme Court on notice to the Attorney General. N-PCL § 1003(b)(2)

   3. The dissolution of the corporation is effective upon the filing of a certificate of dissolution with the Department of State. N-PCL § 1004.

   4. After dissolution, the corporation may not carry on any activities except for the winding up of its affairs, chiefly the payment of its liabilities. N-PCL § 1005.

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