

## **Corporate Clean Up:** it's easy and valuable. By Kevin Quinn and Matt McArdle

In the post Sarbanes-Oxley (SOX) world, many states, including New York, are looking at applying the SOX requirements to not-for-profit entities.<sup>1</sup> (See, for instance, Chapters 263 and 267 of the Laws of 2005 which applied many of the SOX-type requirements to school districts, [http://www.hspm.com/education/School\\_dist\\_acctg\\_problems.pdf](http://www.hspm.com/education/School_dist_acctg_problems.pdf)) In fact, Eliot Spitzer, the front runner for the democratic nomination for Governor, recently introduced a bill to apply SOX-type requirements to not-for-profit entities that have at least \$3 million in assets or receive or accrue at least \$1 million in gross revenue yearly (See, Assembly Bill 10239 and Senate Bill 4836 (2004)) <http://www.hspm.com/governmentrelations/research.htm>).

In our representation of not-for-profit entities, oftentimes we come across some simple requirements that are not being practiced which should be to ensure that your organization gets off to the right start. As the regulatory requirements on not-for-profits continue to be more heavily applied, we advise as a best practice a review of these requirements prior to establishment of a not-for-profit entity. Additionally, an annual review to ensure your organization is in compliance would assist in your efforts to avoid regulatory intrusion. Below, we have highlighted some of those issues which should be reviewed.

### **CORPORATE REQUIREMENTS**

Most not-for-profit entities are established by filing a certificate of incorporation with the New York State Department of State.<sup>2</sup> After this filing has occurred, the following actions must be taken:

1. **Organizational Meeting.** Pursuant to New York Not-for-Profit Corporation Law § 405, an organizational meeting must be held by the initial directors (as set forth in the certificate of incorporation) after the certificate of incorporation has been filed. This can be done without an actual meeting by preparing a written consent in lieu of a Board meeting. The purpose of the meeting is to:

- adopt bylaws;
- elect directors to hold office until the first election of directors as provided in the bylaws;
- elect officers to hold office until the first election of officers as provided in the bylaws;

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<sup>1</sup> Section 1107 of SOX (which applies to entities that receive Federal funds) creates criminal liability if an employer fires or otherwise retaliates against an employee who provides law enforcement any truthful information relating to the commission or possible commission of a federal offense. Additionally, Section 802 of SOX creates a new criminal statute that prohibits knowingly altering, destroying or concealing records with the intent to impede, obstruct or influence any matter involving the Federal government. With regard to non-profits and school districts that receive federal funds, these provisions would apply.

<sup>2</sup> Education corporations, including charter schools, private schools and colleges, are a bit different, but are subject to the same requirements through application of the not-for-profit law by Education law §216-a. In the event of a conflict, though, the Education law controls (Education law §216-a(4)).

- authorize the organization and its officers to prepare and submit a 501(c)(3) application to the IRS; and
- authorize the establishment of a bank account in the name of the organization.

While the statute does not set forth a specific time-frame for holding the organizational meeting, it is recommended that the meeting be held within thirty (30) days after the filing of the certificate of incorporation.

2. Prepare and Submit IRS Application for Recognition of Exemption. After the organizational meeting has been held, not-for-profit corporations must prepare and submit an Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. This application, with all required attachments and explanations, must be filed within 27 months after the end of the month in which the organization was legally formed to ensure that the tax-exempt status will relate back to the date of formation.

3. New York State Charities Bureau. After IRS tax-exempt status has been secured, New York law requires that not-for-profit entities register with the Charities Bureau of the New York State Office of the Attorney General. Once this filing has been made, the not-for-profit entity must also submit annual filings on forms prescribed by the Charities Bureau. There are some exceptions, depending on the size of the funds received by the organization. A good guide for information and answers on this topic, is the Attorney General's website on this issue at: <http://www.oag.state.ny.us/charities/charities.html>

4. New York State Sales Tax Exemption. After IRS tax-exempt status has been secured, not-for-profit entities should also file an application for exemption from New York State sales tax, which allows such entities to make tax-exempt purchases. This can be completed, by filling out and filling

5. Regular Meetings. The bylaws of a not-for-profit entity will ordinarily require that an annual meeting of the Board of Directors be held for the election of officers and directors, and for the transaction of such other business as may come before the Board. Since the terms of the officers and directors generally last one (1) year, it is imperative that such an annual meeting be held to formally elect (or reelect) the officers and directors of the corporation. The actions taken at any meeting, including the annual meeting, should be memorialized by the corporate Secretary in written meeting minutes, which should be maintained with the permanent corporate records.

6. Tax Returns. Finally, all necessary New York State and federal tax returns (including IRS Form 990) must be filed annually for all tax-exempt entities.

### **CONSEQUENCES FOR A FAILURE TO COMPLY**

Failing to comply with the above requirements could jeopardize the tax-exempt status of a given not-for-profit entity, and, in extreme circumstances, could precipitate an action by the Attorney General for judicial dissolution. In addition, from a practical perspective, in the event a not-for-profit entity seeks financing from an institutional lender, that lender will most likely request copies of meeting minutes, and other corporate documentation. In the absence of such documentation, that entity's ability to secure financing may be compromised.

It is also important to note that corporate officers, directors and trustees have a fiduciary obligation to properly carry out the duties of their respective offices. In the event the above corporate requirements are not complied with, such officers, directors and trustees would be in breach of their fiduciary duties which, in an extreme circumstance, could result in the “piercing of the corporate veil” (i.e. exposing that officer, director and/or trustee to personal liability).

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