

# Summary + Analysis of LD 1770

2001 Legislation significantly amending Title 13-B  
of the Maine Statutes: The Nonprofit Corporation Act

This white paper is part of a series of MANP documents created to enhance understanding of the rules and regulations governing Maine's nonprofit organizations.

Members of a working committee worked through the Fall of 2001 and the Winter & Spring of 2002 to create legislation that addressed the needs of many constituents to better regulate nonprofit conversions while not putting undue burden on Maine's nonprofit organizations. This document outlines the changes to Maine's Nonprofit Corporation Act created by this legislation.

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## Part I ~ A Summary of Major Elements

### **New Accountability Rules Increase Compliance Obligations and Expand Attorney General's Oversight of Maine Nonprofit Corporations and Their Directors and Officers.**

*Jim Phipps, Executive Director of the Iris Network  
Formerly an attorney with Preti Flaherty*

#### **Broad New Attorney General Responsibility For Oversight of Nonprofit Corporations**

The new law obligates the Attorney General to enforce "due application of funds given or appropriated to public charities within the State and prevent breaches of trust in the administration of public charities." (see 5 M.R.S.A. 194.2 and 194.4)

#### **New Investigatory Power for the Attorney General**

The Attorney General now has the power to investigate a public charity if he/she reasonably believes that it has engaged or is about to engage in a conversion transaction without compliance with the Nonprofit Conversion Statute, or a misapplication of funds. The investigation requires prior application by the Attorney General to, and approval by, the

superior court on a showing that there is a reasonable basis for the investigation, but this finding may be made without notice to the charity. (see 5 M.R.S.A. 194.5)

## **Nonprofit Conversion Act**

Public charities are prohibited from engaging in conversion transactions unless they are undertaken pursuant to the notice and approval requirements of the new law (see 5 M.R.S.A. 194-B through 194-K). A conversion transaction is defined (with certain exceptions) as

*"the sale, transfer, lease, exchange, transfer by exercise of an option, conveyance, conversion, merger or other disposition or the transfer of control or governance of the assets or operations of a public charity to a person other than a public charity incorporated or domiciled in this State."*

*Penalties for failure to obtain approval of a conversion transaction include:*

- ▶ The transaction is voidable;
- ▶ Judicial removal of the directors and officers;
- ▶ Judicial imposition of civil penalties on officers or directors who receive private inurement or excess benefits in an amount up to 100% of the excess benefit or private inurement received; and
- ▶ Judicial recovery of the costs and fees incurred by the Attorney General in bringing an action to void the transaction or recover civil penalties.

*A public charity may obtain advance approval for a conversion transaction by:*

- ▶ Notifying the Attorney General of conversion transactions with a fair market value in amounts less than \$50,000 (see 5 M.R.S.A. 194-C.1.C and 194-D) at least 20 days in advance of the transaction;
- ▶ Obtaining either Attorney General or court approval of conversion transactions with a fair market value between \$50,000 and \$500,000 (see 5 M.R.S.A. 194-C.1.B and either 194-E or F) by filing a written request for approval with the AG at least 90 days before the proposed transaction and, commencing within 5 days after filing of the request for approval, publication of the first of three weekly notices to the public in newspapers of general circulation in the service area of the public charity; or
- ▶ Obtaining court approval of conversion transactions with a fair market value in excess of \$500,000 (see 5 M.R.S.A. 194-C.1.A and 194-F).

*Costly requirements are imposed on public charities seeking approval under the nonprofit conversion statute including (among other things):*

- ▶ An appraisal must be obtained by the public charity to substantiate the FMV determinations;
- ▶ The public charity must reimburse the costs and expenses of the Attorney General incurred in the course of the approval process.

## **Far Reaching Reform of the Maine Nonprofit Corporation Act**

The new law classifies all Maine nonprofit corporations as either public benefit corporations or mutual benefit corporations. Public benefit corporations are subject to increased oversight from the Attorney General and higher standards of corporate compliance than are mutual benefit corporations.

Public benefit corporations are broadly defined to include (among others) all Maine nonprofit corporations that are either recognized by the IRS as 501(c)(3) organizations, or whose net assets are required to be distributed in the event of dissolution to 501(c)(3) organizations or the government. Maine nonprofit corporations that are not public benefit corporations are categorized as mutual benefit corporations.

## **Enforcement Authority**

Judicial and Attorney General enforcement authority are bolstered under the new law. The Secretary of State and public benefit corporations are required to report certain events to the Attorney General. New enforcement powers include:

- ▶ Judicial removal of directors;
- ▶ Involuntary dissolution upon action brought by the Attorney General;
- ▶ Judicial enforcement of inspection rights of members, directors and officers;
- ▶ Public benefit corporations to notify Attorney General of amendments to corporate purpose statement;
- ▶ Secretary of State to notify Attorney General if a public benefit corporation fails to file a Corporate Annual Report

## **Conflicts of Interest; Duties of Directors and Officers**

Perhaps most importantly, comprehensive changes to the Nonprofit Corporations Act are made concerning conflicts of interest and the legal responsibilities of directors and officers of nonprofit corporations. Each of these topics will be discussed in subsequent issues of this publication.

## **Part II ~ New Rules Pertaining to Conflicts of Interest**

### ***New Conflict of Interest Rules Applicable To Maine Nonprofit Corporations and Their Directors and Officers.***

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The new law repeals prior law pertaining to conflicts of interest and substantially reforms the law of conflicts of interest for Maine nonprofit corporations in three ways:

1. Places a limit on the number of board members who can be considered "financially interested" people;
2. Adds definitions of conflict of interest transactions and institutes new procedures for the approval of conflict of interest transactions that are fair and equitable to the corporation; and
3. Specifies four types of "prohibited transactions" for public benefit corporations. (Note: Discussions in this section include clarification on allowable transfers to a subsidiary or joint venture organized as a for-profit entity)

### **1. The Number of Financially Interested Directors on Boards of Public Benefit Corporations is limited to 49%.**

As of July 1, 2002, the Nonprofit Corporation Act limits the participation of financially interested persons on the Board of Directors of public benefit corporations to no more than 49% of the

directors (see Title 13-B, Section 713-A.2, M.R.S.A.). A "financially interested person" is defined at Section 713-A.1 to include:

- ▶ Any person who receives compensation from the corporation for performing personal services;
- ▶ Any person who is entitled to receive a portion of the net income of a business that provides personal services to the corporation; or
- ▶ Any person who is the spouse, brother, sister, parent or child of any of the foregoing people.

Under prior law, boards of directors could be composed of an unlimited number of interested persons as long as the conflict of interest procedures were used to guide the process of decision-making whenever a conflict of interest transaction arose. The new rule may present some nonprofit public benefit corporations (especially those in rural areas of the state) with the potentially difficult challenge of obtaining well qualified directors from the local business and professional community who are not already engaged by the corporation to provide banking, insurance, accounting, legal, or other goods and services to the corporation.

## 2. Conflict of Interest Definition, Penalties, and Approval Procedures:

**Penalties:** Section 718.2 generally permits conflict of interest transactions if they are either:

- ▶ Fair to the Corporation at the time approved by the Board of Directors, or
- ▶ Undertaken in accordance with specified procedures. (see 13-B M.R.S.A. 718.3 for public benefit corporations and 13-B M.R.S.A. 718.4 for mutual benefit corporations).

If not, then Subsection 718.2 provides that the transaction is voidable and personal liability may be imposed on Directors or Officers.

**Definition:** A conflict of interest transaction "is a transaction in which a director or officer of a corporation has a direct or indirect financial interest (see 5 M.R.S.A. 718.1). A director or officer has an indirect interest in a transaction if:

- ▶ Another entity in which the director or officer has a material interest or in which the director or officer is a general partner is a party to the transaction; or
- ▶ Another entity of which the director or officer is a director, officer or trustee is a party to the transaction.

Compensation decisions are excluded from the definition of a conflict of interest transaction by Subsection 718.9.

**Approval Procedures:** The procedure for board approval of conflict of interest transactions with public benefit corporations is specified at 718.3.A and has two requirements:

- ▶ The board of directors of a public benefit corporation or a committee of the board may authorize, approve or ratify a transaction ... if the material facts of the transaction and the director's or officer's interest are disclosed or known to the board or committee of the board; and
- ▶ The transaction may be approved only if it is fair and equitable to the corporation as of the date the transaction is authorized, approved or ratified.

Section 718.3.B permits a conflict of interest transaction to be approved by the Attorney General or the superior court upon request of either the Corporation, or one or more directors or officers "[i]f the board is unable to make a decision regarding a transaction." Such a transaction will be approved "if it is fair and equitable to the corporation as of the date the transaction is authorized, approved or ratified."

The procedure for approval of conflict of interest transactions by mutual benefit corporations is similar to the procedure for public benefit corporations, but includes no process for Attorney

General approval of these transactions (see 13-B M.R.S.A. 718.4). Instead, as an alternative to board approval, the members of a mutual benefit corporation may "authorize, approve or ratify" such a transaction if the material facts surrounding the transaction and the director's interest are known to them.

Specific standards for voting and satisfaction of quorum requirements to be used when handling conflict of interest transactions applicable to both public benefit and mutual benefit corporations. Section 718.5 provides in part as follows:

[A] conflict-of-interest transaction is approved if it receives the affirmative vote of a majority of the directors on the board of directors of the corporation or on a committee of the board who have no direct or indirect interest in the transaction, but a transaction may not be approved under this subsection by a single director. If a majority of the directors on the board who have no direct or indirect interest in the transaction vote to approve the transaction, a quorum is present for the purpose of taking action under this section.

13-B M.R.S.A. 718.8 provides the Attorney General with authority to bring an action in superior court to void the transaction if a public benefit corporation fails to use the procedure described above if the Attorney General "has reason to believe that the transaction was neither fair nor properly approved."

### **3. Four Types of "Prohibited Transactions" for Public Benefit Corporations**

The third prong of the new conflict of interest rules is found at 13-B M.R.S.A. 721 and applies only to public benefit corporations. Subsection 721.1 creates a category of "prohibited transactions" for certain misapplications of funds or assets of public benefit corporations. The statute also prohibits the directors of a nonprofit public benefit corporation from authorizing such a transaction. The four types of prohibited transactions are as follows:

- ▶ Conflict-of-interest transactions that are neither fair nor properly approved pursuant to section 718;
- ▶ Misapplication of funds or assets in violation of statute, including conversion transactions in violation of the Nonprofit Conversion Act;
- ▶ Any transfer to a director or officer of the public benefit corporation, or to another person in a position to exercise substantial influence over the affairs of the corporation, and constitutes private inurement or excess benefits that exceed the fair market value of the property or services received in return; or
- ▶ Any transfer to a subsidiary or joint venture organized as a for-profit entity.

With respect to the last of these four categories, a transfer to a subsidiary or joint venture organized as a for profit entity may avoid being a prohibited transaction if the Board of Directors makes four express findings of fact before approving the transaction. These four factual findings are as follows:

1. The organization and operations of the for-profit entity will serve, further or support a charitable purpose of the public benefit corporation;
2. The transfer or the commitment to transfer is fair to the public benefit corporation;
3. Distributions of net income by the for-profit entity to owners and investors will be proportionate to their investment interests; and
4. The articles of incorporation, bylaws or similar organizational documents require that compensation transactions between the for-profit entity and investors in the entity or directors or officers of the entity or others in a position to exercise substantial influence

over the affairs of the entity be established in amounts that do not exceed the fair market value of services or property to be provided to the entity.

The statute contains no definition or other clarification of when "the organization and operations of [a] for-profit entity will serve, further or support a charitable purpose of the public benefit corporation." This is likely to inhibit the creation of for-profit subsidiaries because they are generally formed to undertake activities that are not related to the accomplishment of the charitable purposes of nonprofit corporations in order to comply with the requirements of federal tax law applicable to 501(c)(3) organizations.

## Part III ~ Duty + Enforcement Authority Changes

### ***New Standards of Conduct Applicable To Maine Nonprofit Corporations' Directors and Officers and the General Enforcement Authority of the Attorney General Over Maine Nonprofit Corporations is Codified.***

*Jim Phipps, Executive Director of the Iris Network  
Formerly an attorney with Preti Flaherty*

#### **Duties of Directors and Officers**

The former provision of the Maine Nonprofit Corporation Act dealing with legal responsibilities of nonprofit directors and officers (see 13-B M.R.S.A. 716) has been repealed and replaced with three new provisions of law.

- ▶ As pertains to the duties of Nonprofit Directors (See 13-B M.R.S.A. 717); and
- ▶ As pertains to the duties of Nonprofit Officers (13-B M.R.S.A. 719 and 720)

Under prior law, directors and officers were held to the same standard. This standard required them to:

*"exercise their powers and discharge their duties in good faith with a view to the interests of the corporation and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."*

The new law enacts somewhat different standards for directors and officers.

- ▶ **As pertains to the duties of Nonprofit Directors:** The new standard of conduct for directors is similar to prior law, but increases the standard of care by requiring directors to act in the "best interest" of the corporation (see 13-B M.R.S.A. 717.1).
- ▶ **As pertains to the duties of Nonprofit Officers:** The standard for officers (see 13-B M.R.S.A. 720) is quite similar, except that it requires the officer to act in the "best interests of [both] the corporation and its members." (emphasis added) Consequently, under the new law, officers of membership corporations have a fiduciary duty to act both in the best interest of the corporation itself and in the best interest of its members.

#### **Enforcement Authority of the Attorney General**

In addition to the investigatory and enforcement authority of the Attorney General under the Nonprofit Conversion Statute discussed in Part I of this series, the Secretary of State and public benefit corporations are required to report certain events to the Attorney General. Judicial and Attorney General enforcement authority are bolstered under the newly amended Nonprofit Corporation Act in several areas. These enforcement powers include:

1. Judicial removal of directors

2. Involuntary dissolution upon action brought by the Attorney General
3. Judicial enforcement of inspection rights of members, directors and officers
4. Public benefit Corporations to notify Attorney General of amendments to corporate purpose statement
5. Secretary of State to notify Attorney General if a public benefit corporation fails to file a Corporate Annual Report
6. Nonprofit Conversion Statute made expressly applicable to certain sales of assets, mergers and dissolutions

### **1. Judicial removal of directors**

The new law repeals Section 704-5 of the Nonprofit Corporation Act pertaining to judicial removal of directors. New 13-b M.R.S.A. 704-A clarifies and expands the process for judicial removal of directors. It also expands the scope of who may petition the courts for judicial removal of directors of public benefit corporations from the corporation itself or its members, to include the Attorney General.

13-B M.R.S.A. 704-A confers power on the superior courts to remove directors of nonprofit corporations "if the court finds that removal is in the best interest of the corporation" and makes any one of the following three additional findings:

- ▶ The director engaged in fraudulent or dishonest conduct or gross abuse of authority or discretion with respect to the corporation;
- ▶ The conflict of interest rules of Section 713-A have been violated; or
- ▶ A final judgment has been entered finding that the director has violated a duty set forth in section 712 (which prohibits loans to directors) or sections 717 to 720 (the conflicts of interest and standards of care provisions).

### **2. Involuntary dissolution upon action brought by the Attorney General**

13-B M.R.S.A. 1105 has been amended by adding a new Subsection 1105.2-A which gives the Attorney General the authority to petition a court for involuntary dissolution of a public benefit corporation under four circumstances:

- ▶ If it obtained its Articles of Incorporation by fraud;
- ▶ If it exceeds or abuses the authority conferred upon it by law; If its assets are misapplied or wasted; or
- ▶ If it is no longer able to carry out its purposes.

### **3. Judicial enforcement of inspection rights of members, directors and officers**

The expressed statutory duty (at 13-B M.R.S.A. 715 of the Act) to maintain financial records and corporate minutes has been reinforced with judicial enforcement of inspection rights. As under prior law, Maine nonprofit corporations are obligated to keep "correct and complete books and records of accounts," must maintain minutes of the meetings of the directors and any committees having any authority of the directors and membership corporations must maintain a roster of the names and addresses of the members of the corporation.

The new law provides statutory authority for judicial enforcement of directors' and officers' rights to inspect corporate books of account and records including the Corporate Minute Book and financial records when at least five days written notice is given to the corporation. If inspection is denied, a director, officer or member may incur attorney's fees to seek judicial enforcement of his or her inspection rights and the court may award reimbursement of reasonable costs including attorney's fees if it finds that the corporation improperly denied access to the books and records to the member, director or officer.

These rights extend to "voting members" of a corporation so that they are "[enabled] ... to fulfill duties and responsibilities conferred upon members by the articles of incorporation or the bylaws of the corporation or by law." The inspection rights of directors and officers are not so limited.

#### **4. Public benefit Corporations to notify Attorney General of amendments to corporate purpose statement**

The new law adds Section 802.5 to the Act requiring that whenever an amendment to the Articles of Incorporation of a public benefit corporation "results in a material change in the nature of the activities conducted by the corporation," then "the corporation shall give notice to the Attorney General of the amendment simultaneously with the filing of the amended articles with the Secretary of State." The new statute does not explain how one determines when an amendment to the Articles of Incorporation can reasonably be expected to result in a material change in the activities conducted by the Corporation. It may not be fair to interpret the statute as requiring the Attorney General to be notified of all amendments to the corporate purpose statement of any public benefit corporation, but the statute could have broader application under certain circumstances.

#### **5. Secretary of State to notify Attorney General if a public benefit corporation fails to file a Corporate Annual Report**

The Corporate Annual Report filing requirement has been strengthened by adding a new Subsection 4 to 13-B M.R.S.A. 1302 of the Act. This new provision requires that the Secretary of State notify the Attorney General in cases where public benefit corporations are suspended from carrying out activities by reason of failure to file a Corporate Annual Report.

#### **6. Nonprofit Conversion Statute made expressly applicable to certain sales of assets, mergers and dissolutions**

The new law amends 13-B M.R.S.A. 906.1 and adds a new Section 907 applicable to mergers involving public benefit corporations. Among other things, the changes expressly make the nonprofit conversion statute applicable to mergers of public benefit corporations. New Section 907.3 requires that the Attorney General be notified of mergers between two public benefit corporations. New section 907.2 provides statutory authority for the concept that restrictions in wills or restricted gifts apply to the surviving corporation after a merger.

The new law adds a new Subsection 3 to 13-B M.R.S.A. 1001 applicable when a nonprofit corporation disposes of all, or substantially all, of its assets. This new provision requires compliance with the Nonprofit Conversion Statute if the disposition constitutes a conversion transaction as defined in that statute. In the case of a corporate dissolution, if assets of a public benefit corporation are distributed to any entity other than another public benefit corporation, then a Conversion Plan must be filed in accordance with the Nonprofit Conversion Statute (see 13-B M.R.S.A. 1104.1.D).