The Role of the Nonprofit Board of Directors: Legal Responsibilities and Best Practices

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Overview

- The Role of the Board
- Fiduciary Duties of Directors and Officers
- Governance Documents
- Fiscal Oversight and Risk Management
- Questions

The Role of the Board

The Role of the Board

- Uphold the organization's mission

- Ensure the operation of the organization complies with:
  - IRS regulations for tax exempt entities
  - State law, e.g., New York Not-for-Profit Corporation Law ("N-PCL")
  - Employment and other laws
  - Funding obligations and donor restrictions

- Monitor finances and safeguard resources to maintain fiscally sound operations

- Provide support to management

The Role of the Board (cont.)

- Engage in strategic planning and monitor progress through program oversight
- Renew the Board through continuous education, assessment, recruitment, and orientation of new Board members
- Hire, evaluate, and assess executive director's performance
- Serve as an ambassador for the organization

The Role of the Board does NOT include:

- Micromanaging staff
- Managing daily finances
- Running programs
- Ignoring fundraising obligations

Management's Role: Inform and Guide the Board

- Communicate responsibilities effectively
  - Directors want to know what's expected of them

- Work with Board leadership to hold annual and regular Board meetings
  - Prepare agenda, provide financial and program reports

- Keep the Board engaged and hold them accountable

- Celebrate/show gratitude for participation

- Founders must remember that they are subject to board oversight!

Fiduciary Duties

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Fiduciary Duties of Board Members

- Well-established principles of not-for-profit corporation law recognize that nonprofit directors and officers must meet certain legal standards of conduct ("fiduciary duties") in carrying out their responsibilities to the corporation. These fiduciary duties include:
  - Duty of care
  - Duty of loyalty
  - Duty of obedience

- Board structure and governance are important to maintaining public trust in charitable organizations and ensuring that boards function effectively

Duty of Care

- **Duty of Care**: The duty of care requires that directors and officers be attentive to the organization's mission, activities, and finances, and actively oversee the management of charitable assets.
  - The standard of care is the "care that an ordinarily prudent person would exercise in a like position and under similar circumstances"
  - Directors must attend meetings, pay attention, be informed, be diligent, ask questions, use common sense, and attempt to make sound and informed decisions
  - Management or Board should consult with and rely on third parties when appropriate or necessary

Duty of Care - Hypotheticals

Failure to exercise the duty of care:

- $5.5 million settlement obtained by the New York Attorney General's Office against Educational Housing Services, Inc. (EHS) (http://www.ag.ny.gov/pdfs/EHS_AOD.pdf)

Exercising the duty of care:

- A housing organization presented a guaranty to the Board for approval. A Board member realized the guaranty violated a covenant in a credit line agreement.

Duty of Loyalty

- **Duty of Loyalty**: When acting on behalf of the organization, Board members must put the interests of the nonprofit before any personal or professional concerns and avoid potential conflicts of interest.

  – Considerations include:

    a) Legal prohibition on pecuniary profit and financial gain

    b) Compliance with organization's conflict of interest policy

    c) City, state, and federal regulations, including IRS rules

  – Directors should be conscious of potential conflicts, understand and follow organization's conflict of interest policy, and know who is and is not an independent director

Duty of Loyalty - Hypotheticals

Failure to exercise the duty of loyalty:

- Nonprofit hospital owned an adjacent parcel of land. The hospital sold the land to a corporation owned by a hospital trustee. The trustee used the land to build an apartment and office building. The court held that these facts constituted a conflict of interest and were sufficient to void the sale.

Exercising the duty of loyalty:

- Nonprofit decides to purchase a parcel of land. Board member owns 100% of the stock in the corporation that owns the land. Audit Committee reviews the transaction and follows the procedure for a related party transaction.

Duty of Obedience

- **Duty of Obedience**: Directors are required to perform their duties in accordance with applicable statutes and within the terms of the organization's mission and charitable purposes.

  – Duty includes:

    a) Ensuring that the organization complies with relevant laws and regulations, including making necessary filings

    b) Regularly maintaining governance documents

    c) Ensuring that the organization does not engage in unauthorized activities

  – Directors should be conscious of purposes clause in certificate of incorporation, mission statement, if any, and laws pertinent to board activities and responsibilities

Duty of Obedience - Hypotheticals

Failure to exercise the duty of obedience:

- An organization that previously was exempt under a group exemption, was never granted 501(c)(3) status. However each year for the last several years the organization filed a form 990 stating that it is a 501(c)(3) organization. This is a failure of both the duty of care and the duty of obedience.

Exercising the duty of obedience:

- Reviewing the Form 990, ensuring accuracy and that the organization files the Form 990.

Personal Liability: General rule that Board members are not personally liable

- Exceptions:
  - Breach of fiduciary duty
    - AG can bring action for breach of fiduciary duty
  - Where the law imposes legal liability, e.g.,
    - Inappropriate use of assets for personal gain
    - Organization fails to pay employee withholding taxes to IRS
  - Acting in personal capacity
  - Others

- Directors & Officers liability insurance

Business Judgment Rule

- Business Judgment Rule:
  - A presumption that “in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation’s best interest.” (Black’s Law Dictionary)
  - The conduct of directors is subject to the “business judgment rule,” but nonprofit corporations do not have shareholders to monitor their conduct

Protecting the Board from Liability

- Management can help shield the Board members from liability by working with directors to:
  - Run the organization in accordance with law and regulations
  - Purchase D&O insurance
  - Provide for appropriate D&O indemnification in bylaws
  - Engage and consult professionals when needed
  - Manage finances appropriately
  - Remind Board that volunteer (unpaid) directors have certain statutory protections but that is not a substitute for carrying out their duties

Governance Documents

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Proactive Governance Review

- Key Documents:
  - Certificate of Incorporation
  - 501(c)(3) tax-exemption determination letter
  - Bylaws

- Key Policies
  - Conflict of Interest Policy
  - Whistleblower Policy

Certificate of Incorporation

- The Certificate of Incorporation ("COI") establishes the organization as a legal corporate entity under state law, and governs what activities your organization may engage in
- For entities incorporated under New York law:
  - The COI is filed with the NYS Department of State, and certified copies can be requested for a fee
  - Contents include name, purposes for which corporation is formed, duration (if not perpetual), and other items required by statute
  - AG approval is required to amend the purposes clause. The organization will need to demonstrate to AG that charitable donations and other charitable assets will be used for the purposes for which they were donated or otherwise received

- Annual IRS Form 990 Part V (a copy of which is filed with NYS Char500) asks if the organization made any significant changes to its governing documents during the past year, e.g., COI or Bylaws

501(c)(3) Determination Letter

- While formation and the Certificate of Incorporation are a function of state law, it is the IRS and federal law that governs whether the organization is tax-exempt under the Internal Revenue Code and under what category
- The 501(c)(3) determination letter is proof of your organization's tax-exempt status and ability to receive tax-deductible donations from a donor
  - Keep a copy of the letter readily available
- File Form 990s and otherwise abide by relevant rules to maintain 501(c)(3) tax-exempt status, and check IRS Tax Exempt Organization Search Tool to ensure your organization is properly listed (with caveat the IRS is delayed in data updates for this this Tool)

Bylaws

- Set of agreed-upon rules and procedures for the internal operations of a nonprofit corporation
- Prescribe the decision-making processes of the Board and, for membership organizations, the members
- N-PCL establishes the legal framework for bylaws of not-for-profit corporations incorporated under New York law
  - Establishes minimum standards to which the bylaws must conform

Bylaws

- Want to have <u>flexibility</u>
- Should provide clear direction and accurately reflect the practices of the organization
- Clear rules and procedures in the bylaws make it easier for organizations and their Boards to function smoothly and efficiently, and focus on the organization's charitable mission
- Document should be readily accessible so that the Board and staff can regularly refer to it

Bylaws

- Key provisions include:
  - Structure of organization (members vs. no members)
  - Board composition and size
  - Director term length, number of terms, staggering if applicable
  - Removal of directors
  - Officers
  - Quorum requirements for meetings
  - Committees
  - Notice requirements
  - Amendment procedure

Board Composition

- Minimum number of directors in New York is three
- Length of director's term:
  - May not exceed five years; no statutory limit on re-election. N-PCL § 703(b)
  - Terms may be staggered by dividing the directors into classes. N-PCL § 704
  - Exception for *ex officio* Board members
- Members and directors may remove directors for cause. N-PCL §706(a)
- Members may remove directors without cause if authorized by by-laws or COI. N-PCL §706(b)

Committees

- Two categories of committees:
  1. Committees of the Board
  2. Committees of the corporation

- Section 712 of the N-PCL governs Executive Committee and other committees

- Section 712-a governs audit oversight and Audit Committees

Committees (cont'd)

- N-PCL requires election by majority of Board to create a committee of the Board, and such a committee must consist of 3 or more directors. Authority can be in bylaws, COI, or Board resolution. N-PCL §712(a).
- Executive and other committees of the Board (but not committees of the corporation) may have all the authority of the Board, except no committee can:
  - Submit to members any action requiring members' approval
  - Fill vacancies on the Board or committees
  - Fix director compensation for Board or committee service
  - Amend, repeal or adopt by-laws
  - Amend or repeal a Board resolution which by its terms cannot be amended or repealed
  - Elect or remove officers and directors
  - Approve a merger or plan of dissolution
  - Authorize or recommend to members a sale, lease, exchange or other disposition of all/substantially all assets
  - Approve amendment to certificate of incorporation
- Bylaws document is a place to authorize the Board to create additional committees by resolution as needed.

Audit Committee

- Oversees audit, if not carried out by the full Board of directors
- Retains or renews the retention of auditor
- Reviews the results of the audit and any related management letter with the auditor
- Reviews any inadequacies in the audit process
- Reviews and disagreements between auditor and management
- May oversee the conflict of interest policies and procedures
- If applicable, may oversee the whistleblower policy

Audit Committee: Audit Thresholds

- Annual audit required for nonprofits meeting certain annual revenue thresholds:

Annual Revenue	Required Annual Filing with NY AG
Under $250,000	Unaudited financial report
At least $250,000 but not more than $1 million	Financial report with independent CPA's review report
More than $1 million	Financial report with Independent CPA's full audit

Implementation of Committees and Best Practices

- Ensure Executive Committee of at least 3 independent directors so that Board/corporation can act between Board meetings if needed and for strategic oversight

- Audit Committee may oversee audits and the conflict of interest/whistleblower policies and procedures

- Create and use written committee descriptions and charters, as necessary and practical, e.g.:
  - Finance, Development, Investment, Marketing

- Form additional committees by resolution when appropriate, e.g.,
  - Special fundraising event or gala
  - Special programming

- Remember committees of the corporation can include outside advisors and make recommendations but not take Board action

Conflict of Interest Policy

- Specifies the procedure for disclosing a conflict to the Audit Committee or full Board:
  - Ongoing disclosure obligation
  - In conjunction with each annual Board meeting

- Required by New York law
  - All NY not-for-profit corporations must have a conflict of interest policy, laying out how to identify and address related party transactions (may also cover other, non-financial conflicts)

- IRS asks whether an organization has a conflict of interest policy on the Form 990
  - See Part VI, Section B, Question 12(a)

Conflict of Interest Policy: NY-Required Contents

- A definition of what constitutes a "conflict of interest"
- The procedure for disclosing a potential conflict to the Board or designated committee and procedure for determining if a conflict exists
- A requirement that a person with a potential conflict not be present at or participate in Board or committee deliberations or vote on the matter giving rise to the conflict
- A prohibition against any attempt by the person with a conflict to improperly influence the deliberation or voting on the matter
- A requirement that the existence and resolution of the conflict be documented, including in the minutes of any meeting at which the conflict was discussed or voted on
- Procedures for disclosing, addressing or documenting related party transactions

Whistleblower Policy

- Outlines the procedure for reporting suspected improper conduct and addressing such reports
- **Required** for organizations with more than 20 employees *and* revenue of >$1m in prior fiscal year (now required by NY employment law for smaller orgs)
- Generally considered an important part of compliance and risk management

Whistleblower Policy

- N-PCL requires that the policy:
  - include procedures for reporting suspected violations
  - address protection against retaliation
  - designate a person or persons to whom reports can be made
  - outline steps the organization will take to investigate reports
  - designate a person to administer the policy and the requirement for such person to report to a designated committee or the Board
  - be given to all officers, employees, trustees, directors and volunteers

Proactive Governance Review

- Other Important Documents:
  - CHAR 500s, IRS Form 990s, and audited financials
  - Personnel/Employment Policies
    - Employee Handbook
    - Employee Classifications
    - Work for Hire Policy
    - Social Media Policy
  - Document Retention Policy
  - Website Privacy Policy
  - Financial Control Policies
  - Investment Policy
  - Gift Acceptance Policy

Management's Role

- Be an active participant in drafting and reviewing governance documents
- Make sure Board understands their responsibilities generally and under each governance document and annual regulatory filing
- Keep these documents in an easily accessible place
- Review governance documents with the Board on a regular basis, and update as needed
- Obtain or help the Board obtain appropriate legal counsel to assist with amendments, questions, or board training on fiduciary duties and documents

Fiscal Oversight and Risk Management

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What is "Fiscal Oversight"?

- Maintaining the organization's overall financial integrity and accountability
- Protecting the public's interest and ensuring the organization's responsible use of funds
- Ensuring adequate resources for organization's continued existence/operation
- Taking action when necessary to prevent issues from escalating

Fiscal Oversight and Reporting

- Management preparation of budget each fiscal year for review by Board
  - Include sufficient detail to understand revenue and expenses by program area, as well as capital expenditures
- Comparison showing underlying assumptions and significant changes from prior year's budget and actual results
- Distributed five business days in advance of each meeting where there will be approval by the Finance Committee and Board
  - Allow adequate time for review by the Board

Form 990 Information Return

- Different 990 forms are used depending on the gross receipts of the organization
- Form 990 includes:
  - Financial Disclosure
  - Governance Procedures
  - Executive Compensation and Interested Party Transactions

Fiscal Oversight and Reporting: Quarterly Reports

- Quarterly statements prepared for each affiliate and each program
- Quarterly statements of:
  - Profit and Loss Statements
  - Consolidated Balance Sheets
  - Consolidated Cash Flow Statements Sheets
  - Narrative or Comparison of results with key variances from budget and prior year
  - Analysis of Receivables
  - Analysis of Reserves for Bad Debts
  - Recommendations on potential write offs, if necessary

Fiscal Oversight and Reporting: Board and Committee Reporting

- How frequently are management reports provided to the Board?
  - Should be quarterly or at very least on an annual basis
- Any results of a government audit should be reported to the Finance Committee, other appropriate committee and/or Board
- Board review of lines of credit
  - Regular monitoring of credit lines by Board
  - Annual review of other debt (bonds, mortgages, etc.)
- Capital budget and capital projects
- Board should review other fundamental contracts

Management's Role: Keep the Board Informed

- Provide cash flow reports
- Quarterly reports/budgets
- Address variations from budget
- Advise Board of issues
  - upcoming termination of funding or contracts
  - if organization, Board or staff are at risk

Management's Role: Make Sure Board Fulfills Obligations

- Meet annual fundraising obligations/contributions
- Keep Board apprised of where the organization stands
  - Follow-up as necessary with reminders
- Board must review and approve the Form 990
- Board will need to receive enough information throughout the year to review Form 990 in a meaningful way

Risk Management

- Conduct risk assessments for legal, financial, and other risks and encourage Board participation
- Review insurance annually for adequate coverage
- Address cyber security and privacy concerns
- Challenges:
  - Heavily regulated nonprofits
  - Nonprofits with affiliates
  - Organizations with a lot of staff members
  - Making sure Board members have adequate information in the form of third party reports when necessary; understand that volunteer Board members rely on management and third party reports

Next Steps

- Encourage ongoing education
  - Related to nonprofit operations
  - Specifically related to programs
- Invite your Board to attend Lawyers Alliance workshops and webinars
- Call Lawyers Alliance when you have a question about operating your nonprofit

Questions?

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