Nonprofit Board Responsibilities and Liabilities

Becoming a Nonprofit Board Member

When considering the opportunity to join a Nonprofit board, an individual would be wise to spend the necessary time to understand:

•Their **Duties:** including specific skills that make them a desirable candidate and any expected donations or fundraising duties

•The **Organization and its:**
- •Mission
- •Management
- •History
- •Financial Stability
- •Liability Exposures

•Governing **Provisions:** Included in articles of incorporation, by-laws, recent financial statements and audit reports

Duties of Board Members

One of the duties of a board member is the "**Duty of Care**," which involves a director performing his or her duties as a director, committee member, or officer in good faith and in a manner reasonably believed to be in the best interest of the organization. These duties should be performed with such care as a person of ordinary prudence would use in similar circumstances. In the exercise of the "Duty of Care," a director may rely on information and opinions presented by officers or employees reasonably believed to be reliable and competent. They may also depend upon lawyers, accountants, other professionals and experts within their areas of competence and committees within their designated authority, if the director reasonably believes that they merit confidence.

Acts of the board, committees and individual directors are presumed to be in the best interests of the organization unless they involve a breach of fiduciary duty, a lack of good faith, or actions taken in self-interest. Affirmative steps that board members can take to assure that they are fulfilling the Duty of Care are:

- Attend and participate in all board and committee Meetings
- Be familiar with the articles of Incorporation, By-Laws and other relevant documents
- Insist that materials be distributed in advance and review them.
- Ask questions; use independent judgment

Another of the duties of a director is the "**Duty of Loyalty.**" Board members should give undivided allegiance to the organization. Personal, family or business interests cannot be put above the organization's interests, and conflicts of interest in fact and in appearance must be avoided. The three major considerations for fulfilling the "Duty of Loyalty" are confidentiality, business opportunities and conflicts of interest.

With regard to **confidentiality** information presented in board meetings is considered to be confidential unless otherwise specified; in any case, the board should have only one spokesperson.

Business opportunities of which the director becomes aware that may be of benefit to the organization must be presented to the organization first, before any transactions take place.

There are several ways to avoid actual or the appearance of **conflicts of interest:**

- Require that interested parties leave the room during discussions and votes
- Document disclosures in the minutes
- Require completion of an annual questionnaire disclosing relationships with vendors and competitors

A contract or transaction between the organization and a director is not void or voidable solely for that reason if material facts about the contract or transaction are disclosed before the vote and a majority of other directors vote to approve (even if less than a quorum) and the contract or transaction is fair to the organization at the time it is approved.

Intermediate Sanctions are an excise tax imposed by the IRS on "excess benefit transactions" involving "disqualified persons." A tax of 25% of the excess benefit amount may be imposed on the disqualified person.

A disqualified person is anyone in a position to exercise substantial influence over the organization during the previous 5 years. This includes: voting board members; presidents, treasurers, CEOs, COOs, CFOs; family members of the above; and entities where any of the above exercise 35% of control or more.

Excess benefit transactions are defined as transactions where the fair market value of the benefit to the disqualified person exceeds the fair market value of the property or services received by the organization. This definition includes unreasonable compensation.

The IRS rules allow for the principle of a "rebuttable presumption of reasonableness" if:

- The transaction was approved by disinterested directors or a committee, without disqualified person present

- There was a prior review of and reliance on appropriate comparability data

- There was adequate contemporaneous documentation of the basis for the determination

The “**Duty of Obedience”** requires that a director must comply with:

- All applicable laws
- The organization's Articles of Incorporation, Bylaws, and resolutions (directors are guardians of the organization's mission and purpose)
- Any donor restrictions on gifts

The central purposes of the organization should be outlined in articles of incorporation, by-laws, the adopted mission statements and other governing documents. Funding sources rely on this “Duty of Obedience” to know that their funding will be used appropriately.

The “**Duty of Integrity**” involves evaluating all major decisions to ensure that they agree with the organization’s core values.

Financial Responsibilities

The “**Duty to Manage Accounts**” is an obligation to the public and all donors for the proper stewardship of financial resources. Boards have three major financial responsibilities. First, they must set the organization’s financial direction. Then, they must delegate implementation of the financial policies to the Executive Director and monitor their performance. Boards should respect the Executive Director’s authority to make spending decisions, and they should deal with the nonprofit’s business office or bookkeeping staff through the Executive Director. Finally, the board should monitor financial outcomes.

There are a number of ineffective ways for boards to monitor finances. Don’t review a list of bills at board meetings, and don’t permit board members to sign the nonprofit’s checks.

The board should have a Treasurer who manages the board’s review of, and action related to, the board’s financial responsibilities. The Treasurer may work directly with the bookkeeper or other staff in developing and implementing financial procedures and systems.

The Treasurer ensures that appropriate financial reports are made available to the board and regularly reports to the board on key financial events, trends, concerns, and assessments of fiscal health.

The Treasurer Chairs the Finance Committee of the board and prepares agendas for its meetings, including a year-long calendar of issues. The Treasurer makes recommendations concerning the selection of an auditor and meets annually with the auditor in conjunction with the Finance and/or Audit Committees. The Treasurer and the Finance Committee also ensure sound management of investments and maximization of cash flow.

The Finance Committee oversees development of the budget and ensures accurate tracking, monitoring, and accountability for monetary transactions, including theestablishment of adequate internal controls. The Finance Committee should review major grants and make certain that the associated terms are being complied with.

Larger organizations should also have an Audit Committee. This Committee should be comprised of 3-5 board members, and should include financial professionals such as bankers and accountants.

The Audit Committee determines that appropriate accounting policies and internal controls are established and followed, and that the organization issues financial statements and reports on time and in accordance with its regulatory obligations. The Audit Committee also encourages and facilitates communication among the Board, organization management, and external auditors to ensure the open and accurate exchange of ideas and information.

The most common tasks of the Audit Committee are:

- Recommending an independent audit firm to the board of directors
- Reviewing the scope and plan for the independent audit
- Reviewing the results of the audit with the external auditors
- Providing oversight of the internal control structure
- Resolving disagreements between auditors and management

Financial reporting should include monthly, quarterly and annual reports. The monthly reports should include:

- Statement of Position (Balance Sheet)
- Statement of Activities (consolidated) showing budget to actual information
- Departmental Income and Expense Statement showing budget to actual information
- Narrative report including financial highlights, important grants received, recommendations for short-term loans, other means of managing cash flow.
- An executive summary of financial highlights, analysis, and concerns.

Certain additional information could be included in Quarterly Reports, such as fund raising reports, six-month cash flow projections, payroll tax report and fee for service reports (if applicable) showing revenue compared to projections.

The Annual Report should include:

- Annual Federal forms, including 990 and Schedule A; State Reports
- Draft Financial Statements
- Audited financial statements for the entire organization
- Management Letter from the auditor

The purpose of accurate and detailed financial reporting is not simply to assure superior financial management. It also provides vital information to funding sources. Additionally this analysis can assist the Board to detect financial abnormalities. Some of these “red flags” are:

- Complex business arrangements
- Large last-minute transactions
- Unusual accounting policies
- Reluctance to make changes in systems

- Decline in key ratios
- Significant variances in budgets
- Multiple bank accounts
- Large fluctuations in investments

There are a number of analytical techniques for providing supplementary financial information. The Treasurer and Finance Committee and/or Audit Committee should familiarize the Board with financial ratio analysis and trend analysis and explain their significance. [***Do we need more detail here?]***

As vital as the responsibilities for monitoring the financial operations of the organization are, there are other equally important components of the role of Board Member. An important area of concern is risk management. Boards should identify financial, operational and external risks and assess insurance coverage purchased for various exposures. It is also critical to understand and manage internal controls. Factors that need to be addressed are:

- Control objectives – authorization, recording, access to assets
- Management involvement
- Organization structure and management controls
- Key policies and procedures manual
- Segregation of duties
- Record keeping and information system
- Financial reporting system
- Periodic review of the control system
- Cost/benefit analysis

Boards also frequently address management issues. Committees may be established to make recommendations for the solution of problems or the exploitation of opportunities. Often boards are called upon to define the Roles and Responsibilities of staff.

Determining compensation, particularly of key management personnel, is part of the Board's role. Boards become involved in policy making when they define expenditure thresholds and limits of authority. Boards also have a responsibility for reviewing compliance with grant regulations and governmental regulations.

It is incumbent upon the board to monitor performance. Again, because an NFP is not measured by the standard financial scorecard used by businesses, it is critical to establish performance measures with which to gauge achievement of the mission.

The size and complexity of the organization will dictate the sophistication of the measurement system. In most cases an appropriate cost allocation system will facilitate the analysis. One method to measure effectiveness of the NFP uses three essential components:

•**Measure of effort – amount of financial and non-financial resources that are applied to a service.** Financial resources are measured in dollars and non-financial resources in number of personnel.

•**Measure of accomplishment – what was provided and achieved with resources used.** Evaluate the quantity and quality of services provided and what were the outcomes.

•**Measures that relate efforts to accomplishments.** Efficiency can then be determine by comparing the resources employed to the results achieved. What was the cost per successful outcome?

All of these board member responsibilities have associated liabilities. Fortunately the state and federal governments have recognized that these liabilities may be so onerous that they discourage well-intentioned persons from participating on Boards of nonprofit organizations. As a result there are significant legal immunities for personal liability.

The Pennsylvania "Little League" and "Good Samaritan" laws state that no uncompensated officer, director or trustee of a 501(c)(3) organization shall be liable for civil damages as a result of any act or omission unless his or her conduct fell substantially below ordinary standards of care and the person knew or had reason to know that the act or omission created a substantial risk of actual harm.

The Federal Volunteer Protection Act of 1997 exempts 501(c)(3) volunteers from liability for harm caused by acts or omissions if they were:

- Within scope of the volunteer's responsibilities,
- The volunteer was properly licensed (if applicable),
- There was no willful or criminal misconduct, gross negligence, reckless misconduct, or conscious, flagrant indifference to the rights or safety of the individual harmed; and
- The act or omission did not invovle operation of motor vehicle by the volunteer

The Volunteer Protection Act of 1997 does not affect the liability of volunteers to the organization itself or the liability of organization to the injured party. No punitive damages are allowed unless the volunteer is convicted of willful or criminal misconduct or conscious, flagrant indifference to rights or safety of the victim. The liability for non economic loss can only be applied in direct proportion to the percentage of responsibility.

The exceptions for protection under this law are:

- Crimes of violence
- Hate crimes
- Sexual offenses
- Civil rights violations
- Misconduct while under influence of alcohol or any drug

Pennsylvania law also provides specific immunities. If a bylaw amendment so provides, a director shall not be personally liable for monetary damage for any action taken unless the director has breached or failed to perform the statutory duty of care, and

the breach or failure to perform constitutes self-dealing, willful misconduct or recklessness. The exceptions are criminal offenses and liabilities for the payment of taxes pursuant to federal, state or local law.

Also, there are specific regulations for the indemnification by the nonprofit of “representatives of the organization. Indemnification may be applicable to any person who is or is threatened to be made a party to any civil, criminal, investigative or administrative proceeding because he or she is or was a “representative” of the organization. Indemnification can cover attorneys' fees, judgments, fines, and settlement amounts.

It may be provided if person acted in good faith and in a manner he or she reasonably believed to be in the best interest of the organization, and they had no reasonable cause to believe conduct was unlawful. Indemnification may be offered if:

- The board authorizes it by majority vote of disinterested directors or;
- Independent legal counsel approves it in writing or;
- A court orders it or;
- Bylaws mandate it.

It may not be provided where a court determines that the breach constituted willful misconduct or recklessness. It must be provided if the representative is successful on the merits in defense of the action.

Because of the potential liabilities associated with Board membership insurance is essential. Directors' and officers' insurance may include protection against personal liability, even if indemnification is not permissible. The insurance may also provide reimbursement of the nonprofit’s indemnification obligation for defense costs.

Typical exclusions on insurance policies include:

- Dishonest, fraudulent or criminal conduct
- Suits by one director against another
- Libel or slander
- Personal gain
- Bodily injury or property damage
- Violation of environmental regulations
- ERISA claims

Boards should take care to avoid procedural errors. For special meetings, notices should specify the general nature of business to be transacted. Quorum requirements (majority of directors in office unless otherwise specified) should be strictly adhered to. Avoid the ritual approval of reports. Generally speaking mail ballots, and phone polls should be avoided. Directors should never vote by proxy. When the board creates committees, it must be careful not delegate to the committee any of its responsibilities or authorities.

Certain “best practices” apply to the keeping of board minutes. Emphasize actual actions taken not the discussion prior to making decisions. Specify the authorities relied on for decision-making. Clearly identify any documents referred to and avoid lengthy and

imprecise verbiage, inflammatory phrases, or unnecessary personal identification. You should, however, identify directors who voted against a motion or abstained.

Any director who is present at a meeting is presumed to have assented to any motion or decision unless their dissent is entered in the minutes or filed in writing with the secretary before or immediately after adjournment of the meeting. A director who acquiesced in a decision does not have to be identified. If a director believes that their dissent was incorrectly omitted from the minutes, they should notify the secretary in writing promptly upon receipt of their copy of the minutes.

Effective and active boards are critical to the success of nonprofits. To attract good board members, the proper procedures should be used to educate them as to their responsibilities and to minimize their potential liabilities.

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He is a Past member of the Government Finance Officers Association (GFOA), in which he served as a member of the Executive Committee of the Central Pennsylvania Chapter of GFOA and the Special Review Committee for Excellence in Financial Reporting at the national level. He is also a Member of the Institute of Management Accountants, having served as President of the Harrisburg Chapter and as a member of the National Board of Directors.

John has taught courses for the Pennsylvania Institute of Certified Public Accountants and Leadership Harrisburg on subjects related to nonprofit issues. He has also conducted numerous seminars presented to the nonprofit community. He has written articles for the newsletter of the Pennsylvania Association of Nonprofit Organizations and the Tri-State Tax Exempt Roundtable.

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