



**Legal Issues for Nonprofit Board Members**  
**By: Dan Sise, J.D.**  
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**For more information about the NPML Program: [www.umsl.edu/npml](http://www.umsl.edu/npml)**

**Housekeeping:**

- Breaks (2:45)
- Send me an e-mail if you want a digital copy of this outline
- Most “state law” references here are to Missouri law or Illinois law (where applicable)... These are meant as examples, but there are likely similar laws/statutes in your home state...

**Course Content:**

**I. Introduction and welcome**

a. My background

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**II. Nonprofit sector information**

- A. All nonprofits are governed by a “board” of some sort, often called a board of directors, or board of trustees. This is the group, usually made up of volunteers, that is legally, and ultimately, responsible for making sure the organization remains true to its mission, safeguards its assets, and operates in the public interest.
- B. Who’s watching the board of directors?
1. Private watchdog groups like the BBB.
  2. State Attorney General (nonprofit corporation)
  3. Donors

4. U.S. Congress – Senate Finance Committee
  5. IRS (tax exempt status) (**THE BIG DOG**)
    - a. Excellent, and telling remarks and perspective from a speech given by Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities section of the Internal Revenue Service - Before the Georgetown University Law Center Continuing Legal Education seminar on June 23, 2009. Her speech was entitled: “Nonprofit Governance – The View from the IRS”
    - b. Relevant parts of her speech:  
(see: [http://www.irs.gov/pub/irs-tege/ingram\\_gtown\\_governance\\_062309.pdf](http://www.irs.gov/pub/irs-tege/ingram_gtown_governance_062309.pdf))
      - Good governance is important not only because of the nature of the work (done by the nonprofit sector), but because of the sheer size of the sector, and its impact on the economy. The number of approved tax-exempt organizations in 2008 was 1.9 million, and that does not include all churches. This represents a 50 percent increase since 1995. In the three years prior to 2009, the IRS approved more than 200,000 new applications for tax-exempt status – that’s 182 organizations every day, Saturday, Sunday and federal holidays included. Even over the last year the number of applicants has not fallen off, but actually appears to have slightly increased.
      - Charities that are required to file returns with the Internal Revenue Service reported more than \$2.2 trillion dollars in assets in 2005. That was equivalent to the combined assets of the retail trade sector, the transportation sector, and the non-exempt portion of the health care sector.
      - With respect to “good governance” of a nonprofit organization by its board of directors: “Equally important is the principle that the organization’s board should be engaged, informed and independent. The board should have real responsibility and authority. It must, for example, be able to implement, in the life of the organization, the rules against inurement and self-dealing.”
      - During the course of her speech, she did not list or identify a set of universal and mandatory governance principles to be set forth by the IRS. But she did make it clear that the IRS has no intention of walking away from “governance”. (This is in reference to some criticism of the IRS that it should be focusing on “numbers” and “accounting”, and not on governance practices or principles.) It is clear that the IRS will stay engaged in nonprofit governance and how it relates to the risk of noncompliance with the Internal Revenue Code.
- C. “Broad strokes” of the laws and regulations that apply to nonprofit corporations, with tax exempt status:
1. KEY is to think of the two (most likely) sets of oversight, laws, and regulations that apply to your organization: (a) your nonprofit corporation form, and (b) your tax exempt status (HOW MANY IN THE AUDIENCE KNOW their organizational form and tax exempt status??):
    - a. Nonprofit Corporation (State law – State attorney general and/or secretary of state)
      - i. In Missouri: The Missouri Nonprofit Corporation Act is at Chapter 355 of the Missouri Revised Statutes, starting at 355.001, and proceeding through 355.881 <http://www.moga.mo.gov/STATUTES/C355.HTM>

- ii. In Illinois, General Not for Profit Corporation Act of 1986 can be found at 805 ILCS 105 of the Illinois Compiled Statutes  
<http://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=2280&ChapAct=805%26nbsp%3BILCS%26nbsp%3B105%2F&ChapterID=65&ChapterName=BUSINESS+ORGANIZATIONS&ActName=General+Not+For+Profit+Corporation+Act+of+1986%2E>
  - iii. Other states almost certainly have similar statutes...
  - iv. These are the laws that will GOVERN and CONTROL the formation and operation of the nonprofit if they are organized under these provisions
    - So, in other words, a Missouri Chapter 355 nonprofit corporation is governed by...
- b. Tax Exempt Organization (IRS)
- i. With respect to your tax exempt status, the IRS the key:  
<http://www.irs.gov/charities/index.html>  
 - Get to know and love this web site...
  - ii. Particularly excellent IRS info on not only starting a 501(c)(3) organization, but also how to operate a 501(c)(3) organization:  
<http://www.irs.gov/pub/irs-pdf/p4220.pdf>
  - iii. More specific information on proper operation of a 501(c)(3) public charity = Compliance Guide for 501(c)(3) Public Charities (which is probably what you are) at:  
<http://www.irs.gov/pub/irs-pdf/p4221pc.pdf>

### III. Nonprofit Board Member Duties

- A. Why do nonprofits have boards, and what do boards do?  
 From: <http://www.boardsource.org/Knowledge.asp?ID=3.383>
1. Most nonprofits are corporations, which means they are legal entities distinct from the individuals who founded them. Like their for-profit counterparts, nonprofit corporations are governed by boards of directors with legal and ethical responsibilities that cannot be delegated.
  2. MO law on the requirement for a nonprofit corporation to have a Board of Directors:  
<http://www.moga.mo.gov/statutes/C300-399/3550000316.HTM>
    - Must have a "Board", and all corporate powers shall be exercised by or under the authority of, and the affairs of the corporation managed under the direction of, its board...

B. Broad board responsibilities (Also from [www.boardsource.org](http://www.boardsource.org))

1. The board's responsibilities fall into a few broad categories. Think about bringing together a group of board members who can, from the outset, meet the following requirements:
  - a. **Exercise Legal and fiduciary responsibility.** The board is responsible for ensuring that the organization meets legal requirements and that it is operating in accordance with its mission and for the purpose for which it was granted tax-exemption. Individual board members must exercise the duty of care (to be discussed further below). As safeguards of a public trust, board members are responsible for protecting the organization's assets.
  - b. **Exercise Oversight.** The board is responsible for ensuring that the organization is well run. What is best for the "organization" (not the E.D., not the staff, etc.) It moderates the power of management, and has the power to hire and remove the chief executive, usually called the executive director or president.
  - c. **Develop Financial Resources.** As part of their fiduciary responsibility, many board members are actively involved in making sure that the organization has the money it needs. This may include making a personal contribution; serving as an advocate with a foundation, corporation, or government entity; organizing a fundraising event or hosting a benefit; or face-to-face solicitation of other individuals.
  - d. **Provide Representation of constituencies and viewpoints.** Often, board members are chosen so that they can bring to the board the experience or perspective of a particular group or segment of the organization's constituency. Boards are not inherently democratic institutions, but they do provide an opportunity for the groups and communities that a nonprofit serves to have a voice in its governance. However, representing a constituency or viewpoint takes a back seat when voting — all board members are expected to vote with the nonprofit's best interest in mind.

C. More specific information on Board of Directors duties and responsibilities:

1. Ten Basic Responsibilities of Nonprofit Boards

<http://www.boardsource.org/Knowledge.asp?ID=3.368>

- a. Determine the organization's mission and purpose. It is the board's responsibility to create and review a statement of mission and purpose that articulates the organization's goals, means, and primary constituents served.
  - i. Related to this, is a duty to stay committed to, and focused on, the organization's mission and purpose.
  - ii. Some consider this a separate, but related duty – the duty of obedience
    1. The duty of obedience requires board members to be faithful to the organization's mission. It also requires that board members ensure that the nonprofit organization conforms to the purposes laid out in its articles of incorporation. Board members are not permitted to act in a way that is inconsistent with the central goals of the organization, nor should they let the organization stray from its official purpose. A basis for this rule lies in the public's trust that the organization will manage donated funds to fulfill the organization's stated and established mission and purpose.
- b. Select and evaluate the chief executive. Boards must reach consensus on the chief executive's responsibilities and undertake a careful search to find the most qualified individual for the position.
  - i. Ultimately, the Board chooses, evaluates, and possibly decides to get rid of the Chief Executive if necessary

- ii. Even a “founding” president, CEO, or ED can be removed by the Board
  - Example of Millard Fuller and Habitat for Humanity International
- iii. So, on top of all other Board responsibilities, must bear in mind laws for hiring, firing and evaluation of employees, too!!!
  - Note that Charitable organizations are NOT exempt from the extensive body of state, federal and local labor law regulating employment protections and practices
- iv. Also be aware that you cannot set the compensation for your ED “too high” – the IRS looks at practices for setting compensation (for example, recent scrutiny of the compensation of CEO’s of non-profit hospitals)
- c. Provide proper financial oversight. The board must approve the annual budget and ensure that proper financial controls are in place.
  - i. The need for an internal audit, or internal audit committee  
<http://www.boardsource.org/Knowledge.asp?ID=3.111>

In carrying out its oversight responsibilities, the board should regularly review the organization's policies and procedures on how it does business and manages its financial affairs. This task can be delegated to the audit or finance committee.

The committee should guarantee that an adequate internal control mechanism is in place to ensure that the organization is:

- using generally accepted accounting methods
- complying with applicable laws and regulations
- providing reliable financial information
- operating effectively and efficiently

More specifically, an internal audit ensures that proper policies are in place to segregate financial duties, protect cash receipts, require second signatures on large checks, keep track of inventory, require an efficient bidding process, produce timely reports, and maintain accurate recordkeeping. Appropriate internal controls create a firm base for an effective outside financial audit.

- d. Ensure adequate resources. One of the board's foremost responsibilities is to secure adequate resources for the organization to fulfill its mission.
- e. Ensure legal and ethical integrity and maintain accountability. The board is ultimately responsible for ensuring adherence to legal standards and ethical norms.
- f. Ensure effective organizational planning. Boards must actively participate in an overall planning process and assist in implementing and monitoring the plan's goals.

- g. Recruit and orient new board members and assess board performance. All boards have a responsibility to articulate prerequisites for candidates, orient new members, and periodically and comprehensively evaluate their own performance.
  - h. Enhance the organization's public standing. The board should clearly articulate the organization's mission, accomplishments, and goals to the public and garner support from the community.
  - i. Determine, monitor, and strengthen the organization's programs and services. The board's responsibility is to determine which programs are consistent with the organization's mission and to monitor their effectiveness.
  - j. Support the chief executive and assess his or her performance. The board should ensure that the chief executive has the moral and professional support he or she needs to further the goals of the organization.
- D. Beyond the "Basic" responsibilities of nonprofit boards, the following is the legal standard to which nonprofit corporation board members are likely to be held in the event of legal action, investigation by the Attorney General, etc."
- 1. Per the American Bar Association, in section 8.30(a) of its Model Nonprofit Corporation Act: A director shall discharge his or her duties as a director
    - a. In good faith;
    - b. With the care an ordinary prudent person in like position would exercise under similar circumstances; and
    - c. In a manner the director reasonably believes to be in the best interest of the corporation
- E. The Board member Duty of Care, and Duty of Loyalty
- 1. Much of what we just covered in terms of basic duties, broad duties, etc. can ultimately be part of the 2 overriding duties of a nonprofit board member: The Duty of Care, and the Duty of Loyalty.
  - 2. From [www.boardsource.org](http://www.boardsource.org): Under well-established principles of nonprofit corporation law, a board member must meet certain standards of conduct and attention in carrying out his or her responsibilities to the organization. These standards are usually described as the duty of care, the duty of loyalty and the duty of obedience.  
<http://www.boardsource.org/Knowledge.asp?ID=3.364>
3. **Duty of Care**
- a. The "duty of care" describes the level of competence that is expected of a board member, and is commonly expressed as the duty of "care that an ordinarily prudent person would exercise in a like position and under similar circumstances." This means that a board member owes the duty to exercise reasonable care when he or she makes a decision as a steward of the organization.
  - b. Can be very important to meet and satisfy this duty of care because it may protect you as a director from liability, or allow you the protection of indemnification by the organization in the event of liability (as noted above in discussion of the Model Nonprofit Corporation Act)

- c. How do you meet this duty?
  - i. Question: do you have to always make the right decision in order to live up to your duty of care? NO. “perfect judgment and decisions” are not expected or required
  - ii. Meet the basic responsibilities outlined above
  - iii. Also simple things like ACTUALLY ATTENDING the Board and committee meetings, and be engaged and paying attention at those meetings.
    - Don’t “rubber stamp” decisions
    - Be informed – read and understand reports, statements, etc. Foster and engage in meaningful discussion
    - It is ok to rely on statements and data from staff or other board members reasonably believed to be reliable and competent. That is the whole reason for the committee structure of a Board, for example – i.e. the chair of the finance committee (usually the treasurer) reports on the status of the organization’s finances to the board as a whole at board meetings – and the board has ability to believe him or her and take their word.
  - iv. in general, and in many cases, even if a board decision later proves to be unwise, directors will not be liable, and the director will probably be found to have met the requisite duty of care, if the decision (1) was made in good faith, (2) was reasonably believed to be in the organization’s best interest, and (3) was made with independent and informed judgment. (Note similarity to the model nonprofit corporation act language discussed above.)
    - a. This is commonly referred to as the “business judgment rule” and courts use this standard in many cases to see if a director of a corporation lived up to his or her duty of care

#### 4. Duty of Loyalty

- a. The duty of loyalty is a standard of faithfulness; a board member must give undivided allegiance when making decisions affecting the organization. This means that a board member can never use information obtained as a member for personal gain, but must act in the best interests of the organization.
- b. How do you meet this duty?
  - i. Perhaps most important vehicle or safeguard for satisfying the duty of loyalty is a good **conflict-of-interest policy**. A conflict-of-interest policy helps safeguard against organizational conflicts of interest, and should be included in the bylaws for your nonprofit corporation.
  - ii. A conflict of interest occurs when a director has a material, financial, or personal interest in the impending transaction with the corporation.
  - iii. When the personal or professional concerns of a board member or a staff member affect his or her ability to put the welfare of the organization before personal benefit, conflict of interest exists. Nonprofit board members are likely to be affiliated with many organizations in their communities, both on a professional and a personal basis, so it is not unusual for actual or potential conflict of interest to arise.
  - iv. MO law about how to handle conflicts of interest for directors of nonprofit corporations: <http://www.moga.mo.gov/statutes/C300-399/3550000416.HTM>
    1. NOTE that transactions that present or involve a conflict of interest CAN BE approved...

2. Note that conflicts can be approved or waived before they occur— key is for full disclosure, no harm to the nonprofit, and full and detailed consideration and review of possible conflict by the board.
  3. But should you...?? The more you do it, the more you look like you are letting a private person benefit at the cost of, or because of, the nonprofit, tax exempt organization...and the IRS, among others, cares about that...
  4. But what if... "she's giving us a great deal?"
- c. Why must we be concerned about conflict of interest?
- i. Board service in the nonprofit sector carries important ethical obligations. Nonprofits serve the broad public good, and when board members fail to exercise reasonable care in their oversight of the organization they are not living up to their public trust. In addition, board members have a legal responsibility to assure the prudent management of an organization's resources. In fact, they may be held liable for the organization's actions. A 1974 court decision known as the "Sibley Hospital case" set a precedent by confirming that board members can be held legally liable for conflict of interest because it constitutes a breach of their fiduciary responsibility.
  - ii. Nonprofit organizations rely on community support and must be wary of creating the impression that money or resources received from the general public are somehow profiting board members.
  - iii. To maintain federal tax exempt status as a 501(c)(3) corporation, a nonprofit must avoid private inurement, private benefit, and self-dealing. There cannot be any indication that a board member or staff member is somehow siphoning off part of a charity's income or assets for personal use.
- d. Does conflict of interest involve only financial accountability?
- i. No. Conflict of interest relates broadly to ethical behavior, which includes not just legal issues but considerations in every aspect of governance. For example, what if you serve on two board for two organizations that seem to "compete"?
- e. What can we do to prevent conflict-of-interest situations?
- i. From [www.boardsource.org](http://www.boardsource.org): Self monitoring is the best preventative measure. Institute a system of checks and balances to circumvent actual or potential conflict of interest, beginning with well defined operating policies on all matters that might lead to conflict. Most important, create a carefully written conflict-of-interest policy based on the needs and circumstances of the organization. Ask each board and staff member to agree in writing to uphold the policy. A conflict of interest policy should be reviewed regularly as part of board self assessment.
- f. What should be included in a conflict-of-interest policy? A policy on conflict of interest has three essential elements:
- i. **Full disclosure**
    1. Board members and staff members in decision-making roles should make known their connections with groups doing business with the organization. This information should be provided at least annually. Further, on an ongoing basis, directors and staff members should disclose to the board any personal or financial interest they have that might be impacted by a potential board action.
    2. From [www.boardsource.org](http://www.boardsource.org): Use of a disclosure form: An essential part of a strong conflict-of-interest policy is a disclosure form. This is a document that every board member should fill out annually, listing all of his or her

professional, financial, and personal affiliations that might affect his or her independent decision-making capacity during board service. This document serves as a guide to determine conflict of interest when specific issues are handled by the board. The chair should regularly review the documents.

ii. **Board member abstention from discussion and voting.**

1. Board members who have an actual or potential conflict of interest should not participate in discussions or vote on matters affecting transactions between the organization and the other group. To be safe, the director should probably leave the room during board meetings any time discussion revolves around a potential conflict so the other board members can discuss the issues freely.
2. Also, staff members who have an actual or potential conflict also should not be substantively involved in decision-making affecting such transactions.

iii. **The directors approving the transaction in good faith reasonably believe and find that the transaction is in the best interest of the agency**

- g. IRS has a recommended conflict of interest policy: As Appendix A of the instructions form for the 1023 (see page 25 of that document): <http://www.irs.gov/pub/irs-pdf/i1023.pdf>

F. “Other” legal issues, policies, etc. for nonprofit board members to be aware of and think about as they exercise oversight:

1. A note about the Sarbanes-Oxley Act and nonprofit corporations
    - a. In the wake of corporate scandals like the Enron scandal, the Federal government passed the Sarbanes-Oxley Act to mandate a new climate of corporate responsibility and transparency.
    - b. Directors and staff of nonprofit organizations should be aware of this new climate of corporate responsibility, and of rising expectations for the exercise of fiduciary responsibilities of nonprofits and their directors.
      - i. Good indicators that “regulators” and “legislators” will be looking more at nonprofit corporations and issues of corporate responsibility
        1. Senator Grassley and the U.S. Senate Finance Committee...
          - a. **Congressional oversight or future legislation/agency**: (see letter from the Senate Finance Committee at the end of the June 2005 Final Report of the Panel on the Nonprofit Sector convened by Independent Sector ) Per letter from the Senate Finance Committee – Senator Grassley and Senator Baucus:
            - b. “The Senate Finance Committee is deeply concerned about transactions with and within charitable organizations that are inappropriately exploiting charities’ tax exempt status and that may be wrongly enriching individuals and corporations. We are considering a number of comprehensive reforms to protect charities from bad actors and strengthen accountability to donors.”
            - c. For more info, see:  
[http://www.nonprofitpanel.org/Report/final/Panel\\_Final\\_Report.pdf](http://www.nonprofitpanel.org/Report/final/Panel_Final_Report.pdf)
2. IRS study of compensation for CEO’s at large, nonprofit hospitals

- c. Sarbanes-Oxley is federal law specifically applicable to for-profit corporations, and states like MO have not yet passed laws to “officially” make it applicable to nonprofit corporations
  - d. Still, the general mandates of Sarbanes-Oxley provide important guidance for the governance of nonprofit organizations:
    - i. Informed decision making
    - ii. Enhanced scrutiny of organizational transactions
    - iii. Rigorous review of financial data and records
    - iv. Limitation on use of, and payment of, consultants
    - v. Insuring the independence of the audit
    - vi. Avoiding conflicts of interest
  - e. Two provisions of Sarbanes-Oxley ARE applicable to nonprofit corporations:
    - i. Nonprofit corporations must have a policy insuring that documents relevant to an investigation or litigation will not be destroyed. Also note that the form 990, discussed below, asks if a document retention and destruction policy exists in Part VI of that form.
      - 1. This policy probably should be in your organization’s operating policies and procedures and/or your bylaws...
    - ii. Sarbanes Oxley requires that nonprofit corporations must also have “Whistleblower” protection, and a means for reporting questionable financial practices are also required (form 990 asks if one exists in Part VI)
      - 1. QUESTION: what is a “whistleblower”?
      - 2. Someone who takes a bad corporate act, policy, or occurrence to “higher-ups” in the organization to reveal the problem, and, presumably, have it be dealt with and reported as needed
      - 3. Good place to have your whistleblower policy is in your employee handbook – make sure employees know about it, but make sure it gets discussed at the board level, too (VALUE of well kept minutes of meetings of the board of directors)
      - 4. NOTE that if someone is fired for revealing wrongdoing, they can have a VERY STRONG lawsuit against the corporation (for-profit or non-profit) for damages
2. “Lobbying” and political activity
- a. Remember that the degree and kind of political activity allowed to a tax exempt organization depends upon the section of the Internal Revenue Code section under which it enjoys its exemption
  - b. Focus on 501(c)(3) organization)- See IRS guide: <http://www.irs.gov/pub/irs-pdf/p4220.pdf> (see page 3, for example)
    - i. Absolute prohibitions: per IRS regulations for the operation of a 501(c)(3) tax exempt organization, such organizations MUST absolutely refrain from participating in the political campaigns of candidates for local, state, or federal office
    - ii. Example of a Nonprofit getting into trouble for political contributions:
      - 1. [http://onlineathens.com/stories/021709/new\\_389716054.shtml](http://onlineathens.com/stories/021709/new_389716054.shtml)

- c. Board members need to be aware of limitations on “lobbying and political activity” for their own purposes, as a representative of the nonprofit organization, but also to make sure the CEO/ED, or other staff, are not running afoul of such regulations, too...
  - d. For more on what a 501(c)(3) organization can and can’t do in terms of “lobbying”, see the IRS web site for further information:
    - i. <http://www.irs.gov/charities/article/0,,id=163392,00.html>
- G. Who’s checking up on whether you are living up to meeting your duties and responsibilities?
1. There are many “watchdogs” out there, but many are complaint driven, or voluntary
    - a. For example, Attorney General inquiries or investigations are primarily complaint driven. There is no “annual compliance form” or anything like that to file with their office.
    - b. Secretary of State requires annual registration for your nonprofit corporation, but that is not a report or review for practices, compliance, etc.
  2. The IRS requires annual reporting, however, and the best tool the federal government has to determine if your organization and board are living up to the duties and responsibilities of a tax exempt organization on a continuing basis is the IRS Form 990 Annual Information Return.
    - a. **(almost) ALL** 501(c)(3) organizations must file some version of the 990
      - i. There are various forms, depending on the size of your organization: Form 990, Form 990-EZ, or Form 990-PF along with Schedules A and B. Beginning in 2008, even the smallest tax exempt organizations had to start submitting an annual electronic notice using Form 990N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ*, also known as the e-Postcard.
      - ii. There are some exceptions to this filing requirement. For example, “churches” (note that specific definition – vs. “religious organizations”, for example) are NOT required to file some form of the 990. See, page 22 of the IRS publication for Churches and Religions Organizations, for example: <http://www.irs.gov/pub/irs-pdf/p1828.pdf>
    - b. The 990 was revised in 2008, and it now requires tax exempt 501(c)(3) organizations to report on their various governance practices.
    - c. We won’t review the entire form here, but, in sum it’s not just about \$ (although that is a BIG part of the info needed on the form 990), it’s about the way you operate, govern and manage your organization and its assets.
    - d. It is a tool the IRS uses to make sure you are meeting all the requirements that allow you to maintain your tax exempt status
    - e. For example, Part VI of the 990 looks at your governance, management and disclosure policies and practices:
      - i. <http://www.irs.gov/pub/irs-pdf/f990.pdf>
      - ii. “Part VI: Governance, Management & Disclosure” Note especially “Section B” in Part VI: “Policies” – i.e. written conflict of interest policy.

1. Interestingly enough, the IRS does NOT require that you have a conflict of interest policy (see, for example, page 9, of the instructions for form 1023)... But they still ask if you do...
  - f. And just so you know that the IRS really is checking up on 501(c)(e) organizations...and sometimes REVOKING their 501(c)(3) status:  
See: <http://www.irs.gov/charities/charitable/article/0,,id=141466,00.html>
3. Going back to the Attorney General, it is clear that the Attorney General is going after “fraudulent” charities where members of the Board of Directors clearly are not living up to their duties, oversight responsibilities, or governance requirements:
  - a. St. Louis Business journal on-line article on 5/20/09 about MO and IL AG’s going after illegit charities:
  - b. <http://stlouis.bizjournals.com/stlouis/stories/2009/05/18/daily30.html?surround=lfm>
  - c. Where was the board of directors’ oversight?
  - d. Another often cited example: In MO: Nixon v. Lichtenstein, 1997 case resulting from legal action by MO Attorney general Jay Nixon against a charitable foundation and its board members for, among other things, payment and receipt of compensation, and use of corporate funds.
    - i. MO Atty General sued to remove two directors from the board of a charitable corporation AND for reimbursement of funds expended on their behalf
    - ii. Example of what can happen when directors ignore their duty of loyalty and seek to profit for themselves, and to the detriment of the nonprofit corporation.

#### IV. Nonprofit board member liability, and protection from liability

- A. Possible liability of the Directors for acts of the nonprofit corporation
  1. Beyond the general and overarching duties and responsibilities covered here, it is important to generally remember that members of the board of directors can be liable for the acts of the nonprofit corporation.
  2. Definition of Liability: the condition of being actually or potentially subject to a legal obligation; legal responsibility for one's acts or omissions.
  3. Directors can be responsible for the acts or omissions of the nonprofit corporation, or their own acts or omissions
    - a. A nonprofit corporation is an “entity” (like a person), and it can take actions, or fail to take actions.
    - b. If a nonprofit is sued, here is how it is likely to work, in terms of who gets named in the suit...
- B. But there are also many practices and laws that work to shield directors in nonprofit organizations from liability.
  1. The nonprofit corporate form itself provides board members with a level of legal protection from liability

- a. If you are thinking about joining the board of... find out more about the “form” of the organization – is it organized as a nonprofit corporation under Missouri (or other state) law...?
  - b. A corporation is a legal entity that exists in perpetuity until it is dissolved (so it can go on beyond a human life and do good things even longer). It is a ‘fictitious person,’ separate from its managers or governors, and is usually given many of the same rights and obligations as natural persons. A nonprofit corporation is able to conduct charitable, educational, or scientific activities; it can enter into contracts; it can incur debts; it can hire employees who are eligible for fringe benefits; and it is legally liable for its actions.
  - c. The main benefit of being incorporated is the limited liability that it provides for those managing or governing the organization. All debts and obligations are in the name of the corporation. As long as the managers and board members act reasonably and with care, and put the benefit of the organization ahead of their personal gains, they may be absolved from personal liability. Incorporation is the first step in risk management.
  - d. That said, there is not any “blanket immunity” for the nonprofit organization itself in Missouri – in other words, just because you are a nonprofit, and you are out there “trying to do good” doesn’t give the organization itself an automatic, or blanket, immunity from liability:
  - e. There used to be a kind of blanket immunity for nonprofit organizations in Missouri, but court decisions in the 1960’s took away that blanket immunity
    - a. See, for example: Hill v. Boles 583 S.W. 2<sup>nd</sup> 141 MO 1979
    - b. Also: Abernathy v. Sisters of St. Mary’s 446 S.W. 2<sup>nd</sup> 599 (Mo. Banc 1969), and Garnier v. St. Andrew Presbyterian Church of St. Louis 446 S.W. 2<sup>nd</sup> 607 (Mo banc 1969) (APPARENTLY these two cases were the death-knell of the doctrine of charitable immunity in MO)
2. Other forms of review, analysis, and “risk management” will also help you avoid liability
- a. Five basic steps for developing sound decisions of almost any kind for your nonprofit in the face of planning: partially taken from <http://nonprofitrisk.org/tools/hallmarks/intro.shtml>:
    - i. Consider the consequences – both intended and unintended.
    - ii. Consider the likelihood of those consequences.
    - iii. Consider the odds.
    - iv. Listen to your intuitions and experience.
    - v. Be wary!
  - b. It is not fun to be the person who “focuses on the negative” – but every organization needs SOMEONE (Board member, staff member, or other) who steps back and takes a critical view or analysis of an idea, or situation, or plan.
  - c. Everyone moving in lock-step is a bad idea... critical review is not just focusing on the negative – it can help with planning, preparation, and contingency plans
  - d. Think about need for at least one person to be the “contrarian” on your board, or on your staff, so you are more likely to engage in actual, CRITICAL, review – and don’t criticize that person for being “contrarian” – they could well be doing you a service.

- e. Put thought into crafting policies and procedures for activities, programs, operations, etc., and then follow those policies and procedures...
    - i. Will help keep your organization, and your "people" safe
    - ii. Will reduce possibility of liability
3. Laws that shield directors and board members from liability – immunity provided by statute:
- a. There is a Federal Volunteer Protection Act that provides protection against suits for "volunteers", with some limits and exceptions:
    - i. <http://uscode.house.gov/download/pls/42C139.txt>
    - ii. Note this is broad protection for all volunteers from those volunteering on a one-time basis, up to volunteer board members
    - iii. Note the limits to, and exceptions to, the protections in this Act:
      - a) Liability protection for volunteers
 

Except as provided in subsections (b) and (d) of this section, no volunteer of a nonprofit organization or governmental entity shall be liable for harm caused by an act or omission of the volunteer on behalf of the organization or entity if -

        - (1) the volunteer was acting within the scope of the volunteer's responsibilities in the nonprofit organization or governmental entity at the time of the act or omission;
        - (2) if appropriate or required, the volunteer was properly licensed, certified, or authorized by the appropriate authorities for the activities or practice in the State in which the harm occurred, where the activities were or practice was undertaken within the scope of the volunteer's responsibilities in the nonprofit organization or governmental entity;
        - (3) the harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer; and
        - (4) the harm was not caused by the volunteer operating a motor vehicle, vessel, aircraft, or other vehicle for which the State requires the operator or the owner of the vehicle, craft, or vessel to -
          - (A) possess an operator's license; or
          - (B) maintain insurance.
    - iv. Note that this Act does not provide immunity to the nonprofit organization itself (and this is a recurring theme...)
      - c) No effect on liability of organization or entity
 

Nothing in this section shall be construed to affect the liability of any nonprofit organization or governmental entity with respect to harm caused to any person. (in other words, even if the volunteer

might not be liable, the nonprofit itself could still be liable)

- b. Missouri has a similar state law that applies to the **non-board-member** volunteer:
  - i. In MO: <http://www.moga.mo.gov/statutes/C500-599/5370000118.HTM>
    1. Any volunteer of a nonprofit organization or governmental entity shall be immune from personal liability for any act or omission resulting in damage or injury to any person intended to receive benefit from such volunteer's service if:
      - a. The volunteer acted in good faith and within the scope of his official functions and duties with the organization or entity; and
      - b. The damage or injury was not caused by the intentional or malicious conduct or by the negligence of such volunteer.
    2. Nothing in this section shall be construed to create or abolish an immunity in favor of a nonprofit organization or a governmental entity.
  - ii. Note SPECIFIC language in the statute that differentiates it from 537.117 (discussed below...)
- c. Missouri then goes even farther to provide specific statutory protection from liability to the board members of (some) nonprofit organizations:
  - i. <http://www.moga.mo.gov/statutes/C500-599/5370000117.HTM>
  - ii. Any officer or member of the governing body of an entity which operates under the standards of section 501(c) of the Internal Revenue Code of 1986 (thus, another reason to seek designation as a tax exempt 501(c) organization from the IRS – it is NOT enough to be incorporated as a nonprofit corporation in MO...that does not qualify for this protection... also, think about small churches, for example, that never formally applied for tax exempt status... also, note how broad this is – i.e. not just 501(c)(3) organizations, for example...), who is not compensated for his services on a salary or prorated equivalent basis, shall be immune from personal liability for any civil damages arising from acts performed in his official capacity. (by the breadth of this language, would seem to even apply to liability for employment practices in hiring and firing of the chief executive, for example?) The immunity shall extend only to such actions for which the person would not otherwise be liable, but for his affiliation with such an entity. (note exceptions:) This immunity shall not apply to intentional conduct, wanton or willful conduct, or gross negligence. Nothing herein shall be construed to create or abolish an immunity in favor of the entity itself.
  - iii. In recent look up of information where this provisions was cited by Missouri courts, I found almost nothing... Does not appear to be any current case law interpreting or setting out the breadth of this statutory provision...

iv. IL has a similar statute/protection (805 ILCS 105/108.70):  
<http://www.ilga.gov/legislation/ilcs/ilcs4.asp?DocName=080501050HArt%2E+8&ActID=2280&ChapAct=805%26nbsp%3BILCS%26nbsp%3B105%2F&ChapterID=65&ChapterName=BUSINESS+ORGANIZATIONS&SectionID=64818&SeqStart=6700000&SeqEnd=8600000&ActName=General+Not+For+Profit+Corporation+Act+of+1986%2E>

d. Question – why should we have laws in place that protect directors of nonprofit corporations from liability? Laws are in place to help protect directors of nonprofit corporations – and thereby encourage people to be on boards of directors, and to also recognize the fact that these people are giving their time, money and expertise usually without charge and for the sake of the common good.

4. Beyond laws that provide immunity to nonprofit board members, you should also be protected by (A) a guarantee of indemnification by the nonprofit itself, and (B) insurance coverage purchased and maintained by the nonprofit itself

a. Indemnification

i. Indemnification: Compensation for loss or damage, or, sometimes, for liability before loss even occurs; to provide security for financial reimbursement to an individual in case of a specified loss incurred by the person.

ii. Nonprofit organizations should have a policy and procedure in their bylaws for indemnification and protection of directors in the face of liability

iii. Sample indemnification language for bylaws...

- Inclusion of a policy for indemnifying directors (i.e. protecting directors from liability, or reimbursing them in the event of liability or legal action) can be an important part of attracting and keeping board members

- Purpose of these indemnification provisions is to give the corporation the authority to provide financial compensation to directors for expenses and liabilities they may incur in connection with actual or threatened civil or criminal actions or investigations connected to their service to a corporation.

- Example of expense covered: attorneys fees is the usual and big one

iv. If your bylaws do not set out your policy for indemnification of a director/board member, then a Missouri statute REQUIRES indemnification, per the following provision: <http://www.moga.mo.gov/statutes/C300-399/3550000471.HTM>

- note that language is “SHALL indemnify”...

v. IL has a similar provision in its Not-for-Profit Corporation Act at 805 ILCS 105/108.75

<http://www.ilga.gov/legislation/iles/iles4.asp?DocName=080501050HArt%2E+8&ActID=2280&ChapAct=805%26nbsp%3BILCS%26nbsp%3B105%2F&ChapterID=65&ChapterName=BUSINESS+ORGANIZATIONS&SectionID=6481>

- b. Insurance coverage
- i. Nonprofit organization board members will be, or can be, covered by a couple forms of insurance policies
  - ii. General tip: whenever a problem comes up, look to your insurance first
  - iii. Every nonprofit should have a “CGL” or Commercial General Liability policy of insurance... Board members could be covered under this insurance policy in some instances, and for some occurrences...
  - iv. More specifically related to your duties as a nonprofit board member, your nonprofit should have a “D&O Policy” – which is an insurance policy for Directors and Officers liability
  - v. Directors and Officers Insurance
    - from: <http://www.boardsource.org/Knowledge.asp?ID=3.151>
    - Even the most proactive risk-management policies and procedures cannot ensure that a board member will not be implicated in a legal suit while acting on behalf of the organization. Indemnification clauses in the bylaws and state and federal laws may provide some protection for some causes of action, but purchasing Directors' and Officers' (D&O) insurance is highly recommended, particularly if your nonprofit has employees.
    - Directors' and Officers' insurance is a specific insurance policy to safeguard board members and the organization for causes of action not covered by a general liability policy. D&O insurance is a separate policy from the general liability policy. An important benefit of D&O insurance is broad coverage for employment-related claims.
    - If your nonprofit has employees, it is important to determine that your D&O policy provides broad coverage for these types of claims. Typically, a D&O insurance policy will provide both defense and indemnification for the individual directors and officers and the organization. Since each insurance company offers a different policy form with distinctions that could dramatically alter coverage, it is important to check the specific language on your policy.
  - vi. Some would say that you might not need this... that you could save on the cost...
    - personally, I disagree, and believe it is worth the relatively minimal cost both for insurance value itself, but also as an additional factor in recruiting board members...
    - I think it is also important to realize that promise of, and policy for indemnification of directors is almost worthless if you don't have the

resources to provide this indemnification. D&O Insurance provides you with these resources.

## V. Board diversity

### A. Work to have a Diverse Board

Partially from: <http://www.boardsource.org/Knowledge.asp?ID=3.100>

- not just racial diversity, but diversity of skills, backgrounds, perspectives, etc.

A homogeneous board may not always be ready to deal effectively with problems due to an inherent near-sightedness. Diversity on a board breeds varying opinions, approaches, attitudes, and solutions. It requires open-mindedness, curiosity, acceptance, and responsiveness, which can ultimately facilitate understanding and willingness to work together. This is clearly not the easiest way to get a group to make decisions, but different or opposing backgrounds, cultures, beliefs, habits, and norms can necessitate a consensus-oriented approach to conflict management.

Boards are often expected to represent the organization's constituency. This is a way to create accountability and form a link with the constituents. A uniform board may not make the necessary effort to create this sense of community leadership.

Diversity for the sake of diversity, even without pointed constituent representation, can form a base for innovation and creative thinking.

A diverse board sends a message and sets a powerful example for the entire organization.

### B. Make a commitment to recruit "diverse" board members...

1. Start with a board resolution...

### C. Think about the opportunity to add someone who is "against" your organization as a way to add "diversity", too...

1. Helps you learn what "the other side" is thinking...
2. Might be a chance for your organization to "win hearts and minds"
3. Don't do this at the risk of adding a distraction to your board, though...

## VI. Discussion of future issues or trends, wrap-up, and questions

### A. Although you are a "not for profit" organization, think about running your organization like any other business... You are not just about your mission – you are also (likely) a nonprofit CORPORATION...

1. Good records
2. Established policies and procedures
3. Insurance
4. Etc.

### B. The future likely holds requirements for more oversight and scrutiny for nonprofit organizations

### C. Past examples showing future trend...?

2. Revised form 990
  3. ALL nonprofits must now file some form of the 990 – even the very small nonprofits must file the 990N
  4. Sarbanes Oxley
  5. IRS study on compensation for executives at nonprofit hospitals
  6. Senator Grassley and the Senate Finance Committee
  7. Relating back to the beginning, and the speech by Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities section of the Internal Revenue Service:
    - the IRS has no intention of walking away from “governance”. (This is in reference to some criticism of the IRS that it should be focusing on “numbers” and “accounting”, and not on governance practices or principles.) It is clear that the IRS will stay engaged in nonprofit governance and how it relates to the risk of noncompliance with the Internal Revenue Code.
  8. All showing need for board members that understand, and live up to, duty of care and duty of loyalty...
- D. In exercising your duties as a director, be confident in the various forms of protection you have from liability, but still be conscientious and vigilant to avoid potential liability
1. Make well informed decisions
  2. Don't just focus on the mission – remember you are there for governance of the organization itself. As a board member, you should no longer be focused solely on providing meals, or pounding nails, or tutoring kids... You should make sure the organization itself is well run and well governed so it can go on providing those much needed services...
  3. As your organization grows in size, prestige, etc. – make sure you keep “worker bees” on your board who can actually mind the store... That's what the IRS wants...