THE RULES OF ENGAGEMENT: MANAGING LIABILITY FOR NONPROFIT BOARDS

By

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I. Introduction. Directors of nonprofit boards face incredible stress as they struggle to operate charities at a time when funding is scarce, criticism of nonprofit misfeasance and malfeasance is high, and demand for accountability is strident. Although individuals comprising nonprofit boards hail from a variety of economic, business, and social backgrounds, they have one thing in common: few understand their responsibilities as a nonprofit board member, appreciate the liability involved, or have been trained to properly exercise their board role. Every board member should have a clear understanding of his or her role and responsibilities, the elements of governance with the greatest risk, and the most effective methods of liability management.

A. The Difficult Nonprofit Environment.

1. Nonprofit Contributions are Down. The U.S. economic downturn of the past three years has reduced funding to charities in three areas: individual gifts, foundation grants, and government grants. As a result, many charities have laid off staff, reduced programs, and struggled to keep bills current.

- Individual donations have slowed as donors who have suffered personally from lower income and asset levels have responded by reducing their charitable giving. The most recent figures from the American Association of Fundraising Counsel Trust for Philanthropy *Giving USA 2003* reporting 2002 giving levels are shown in Table 1.[2]

TABLE 1
AAFRC GIVING USA 2003 CONTRIBUTION SOURCES

Source	Amount (in Billions)	Increase/Decrease Over 2001	Increase/Decrease Adjusted for Inflation (1.56%)
Individuals	$183.73	.7%	-.9%
Bequests	$18.10	2.0%	.4%
Foundations	$26.90	-1.2%	-2.7%
Corporations	$12.2	10.5%	8.8%
Total	$240.92	.9%	-.5%

- Foundations have lost asset value, leading to a decline in the number and size of charitable grants. (Private foundations are required to distribute 5 percent of their investment assets annually.)
- Governments – federal, state, county, and local – have decreased grants and funding as tax revenues have decreased and basic operating demands have increased.

2. Investment Markets Have Ravaged Reserves. The three-year bear market and 45-year lows in interest rates have had a dramatic impact on charitable resources. Charities relying on internal investment returns to fuel operations have had to look to other sources of revenues as charities lost ten, twenty, or even fifty percent of their assets. The whipsaw effects of the market returns are shown in Table 2.[3]

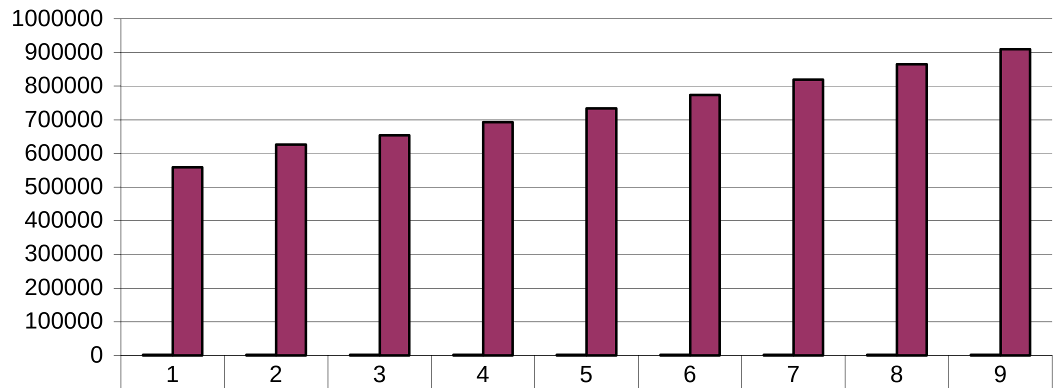
TABLE 2
MAJOR MARKET INDEX RETURNS 1999-10/2003

Index	1999	2000	2001	2002	2003 (1/1-9/30)[4]
Stocks					
Dow Jones Industrial Average	25.22%	-6.18%	-7.10%	-16.76%	11.19%
S&P 500	19.53%	-10.14%	-13.09%	-23.37%	13.20%
NASDAQ	85.50%	-39.29%	-21.05%	-31.53%	33.80%
DJ World (excluding US)	31.54%	-17.36%	-21.02%	-15.63%	19.65%
Bonds					
Long Treasury Bond*	-15.13%	20.11%	3.50%	14.62%	3.40%
Municipal – Tax Free	-6.34%	17.10%	4.50%	10.73%	1.03%
Corporate – Investment Grade	-1.89%	9.10%	10.70%	10.17%	7.61%
Corporate – High Yield	2.51%	-5.10%	4.50%	-1.89%	20.21%

3. New Nonprofits are Emerging, and Old Nonprofits are Soliciting Funds for the First Time. Most nonprofits have seen increasing competition for funds as the number of nonprofits has grown, and the number of tax-exempt entities soliciting funds has

increased. The growth in the number of tax-exempt entities from 1994 to 2002 is shown in Table 3.[5]

TABLE 3
GROWTH OF THE NUMBER OF TRADITIONAL CHARITIES 1994-2002



Year	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of Entities	558,745	626,226	654,186	692,524	733,790	773,934	819,008	865,096	909,574

B. <u>Heightened Expectations of Accountability</u>. Headlines across the country have detailed corporate and nonprofit scandals involving fraud and mismanagement.[6] These stories prompted Congress to legislate accountability (The American Competitiveness and Corporate Accountability Act of 2002, also known as the Sarbanes-Oxley Act[7]) and increased scrutiny of the charitable sector. The Sarbanes-Oxley Act requires corporate boards to: maintain an independent and competent audit committee; hire an independent auditing firm not compensated by the corporation for other types of services (delineated in the statute); rotate the reviewing partner of the auditing firm at least every five years; have the CEO and CFO certify the company's statements (with criminal penalties for intentional false certification); prohibit loans to corporate directors and executives; and disclose internal control processes, corrections to past financial statements, off-balance sheet transactions, and material changes in operations or financial condition. While these provisions were directed at for-profit corporations, these standards may eventually be imposed on the nonprofit community, especially if stories of misuse of charitable funds continue.[8]

II. <u>Nonprofit Board Responsibilities</u>. Nonprofit board members are charged with governance and assume personal responsibility for the charity's actions and assets.

A. <u>Terminology.</u>

1. <u>Who are "Directors"?</u> The term "directors" is used throughout to designate the individuals with responsibility for oversight and management of a § 501(c)(3) organization whether the charity's governing documents refer to them as directors or trustees. The key is the voting responsibility imposed upon the individual. The analysis herein does not apply to "honorary board members," "emeritus board members," or other director positions without the accompanying ability to vote and make binding decisions on behalf of the charity.

2. <u>Is a Board Member a Fiduciary?</u> "Fiduciary" is a broad term describing the duty to control, manage, and make decisions about assets held for the benefit of another. *Black's Law Dictionary* describes a fiduciary as "(1) One who owes to another the duties of good faith, trust, confidence and candor, and (2) One who must exercise a high standard of care in managing another's money or property." Board members – whether governing a nonprofit corporation or serving as a trustee of a charitable trust – serve in a fiduciary capacity, managing the assets of the charity for the public good.

3. <u>The Standard of Care.</u> One of the challenges in advising clients about director liability is determining the applicable standard of care. The standards applicable to directors derive from the strict fiduciary standards of common law. However, applications vary depending upon the charity's organizational form (nonprofit corporation or trust), its federal tax form (public charity or private foundation), and its situs (state law).

    a. <u>Nonprofit Corporation vs. Trust Form</u>. A nonprofit is created under state law and may generally take the form of a nonprofit corporation, a trust, a limited liability company, or an entity without organized form. (State law determines those options.) Most charities operate as a nonprofit corporation or trust, with the former being the most predominant. Historically, charity directors were held to the strict standard of a trustee, which required the exercise of the care and skill of the prudent man, and held the trustee personally accountable for failure to comply, "even though he does the best he can."[9] For the last several decades, the courts have made a distinction between the trust and corporate standards, applying a less stringent standard for nonprofit directors than trustees. (See *Stern v. Lucy*

Webb Hayes National Training School for Deaconesses and Missionaries, et. al., 381 F. Supp. 1003 (D.D.C. 1974) [a/k/a the "Sibley Hospital Case"].) The focus throughout is on nonprofit corporation law, although distinctions in trust liability are noted where appropriate.

b. Public Charity vs. Private Foundation. All charitable entities are classified as private foundations unless they meet one of four exceptions: (1) traditional charities described in IRC § 170(b)(1)(A) (except those described in clauses (vii) and (viii); (2) charities normally receiving 1/3 or more of their support from the public and less than 1/3 of their income from investment income and unrelated business taxable income (net of tax); (3) supporting organizations; or (4) organizations devoted to testing for public safety. [10] The distinction is important since directors of private foundations may have personal liability for self-dealing, taxable expenditures, jeopardizing investments, and political expenditures.[11] Distinctions between public charities and private foundations are also noted where appropriate.

4. The Revised Model Nonprofit Corporation Act (1987).[12] In 1987, the American Bar Association's Nonprofit Corporations Committee in the Section of Business Law promulgated model standards for state nonprofit corporation laws. The Revised Model Nonprofit Corporation Act (1987) (hereinafter The Model Act) provides guidance on standards for directors and the operations of nonprofit corporations; many states have adopted these standards in whole or in part. References to sections of The Model Act are found throughout these materials.

B. A Board's Basic Duties. Two categories of duties apply to board members: codified responsibilities (many of which derive from the common law) and the practical responsibilities common to nonprofit management.

1. Codified Fiduciary Duties. Directors have three primary fiduciary responsibilities: the duties of care, loyalty, and obedience. These duties developed through years of care law and are now generally incorporated in state law.

a. Duty of Care. The duty of care requires a board member to participate in the activities of governance, provide operational and policy oversight, and exercise a reasonable level of care in making decisions on behalf of the organization. The Model Act describes the corporate duty of care as follows: "A director shall discharge his or her duties as a director, including his or her duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.[13] (Trustees have a similar duty to exercise reasonable care and skill as a "man of ordinary prudence would exercise in dealing with his own property."[14])

Examples of an exercise of care include:

- Participation in board and committee meetings;[15]
- Familiarity with the board's business plan and strategic plan;
- Review of the charity's budget, fundraising results, audited financial statements, and investment returns on assets;
- Review of board and committee minutes (which should be requested if for some reason these documents are not produced);
- Review of agents appointed by the charity to carry out delegated duties;
- Familiarity with policies governing the handling donations, money movement, asset management, employee management, and other areas of risk; and
- Queries when necessary to clarify facts, and forming independent judgment about decisions to be made.

Directors are not liable for decisions – even if in hindsight such decisions are unwise – so long as those decisions are informed, made in good faith, and without a conflict of interest.[16] The board member does not generally have a duty to look behind the information provided unless he or she has reason to believe it is incorrect.[17] Most state statutes (and the Model Act) expressly allow board members to rely on information provided to them by staff, legal counsel, accounting counsel, other professional advisors, a committee of the board, or religious leadership.[18]

b. Duty of Loyalty. The duty of loyalty focuses on conflict of interest, disclosure, and confidentiality and requires the director to place the interests of the charity above his or her personal interests when serving as a director. A director should not vote on a matter affecting the nonprofit in a way that benefits him or her personally at the expense of the nonprofit, should not use information obtained through service as a director for personal benefit or for the benefit of third parties outside the charity (corporate opportunity), should not take excessive compensation, should not solicit or accept loans from the nonprofit, and should reveal all conflicts or personal benefit that may result from a vote of the nonprofit.

In addition to the duty imposed by state statute, four other sets of rules impact the director's duty of loyalty:

1). Private foundation self-dealing rules. Private foundations and certain split interest trusts are governed by self-dealing rules[19] that prohibit certain transactions between the trustee and disqualified persons (a term that includes directors and most family members of directors[20]). The self-dealing rules prohibit sales between the disqualified person and the foundation, limit fees for professional services to those that are necessary to carry out the foundation's tax-exempt purpose and reasonable, prohibit loans between the foundation and the disqualified persons, and generally forbid other transfers of money or property between the foundation and disqualified person without regard to the fairness or arms length nature of the transaction.[21]

2). IRS Intermediate Sanctions for private inurement.[22] In 1996, Congress imposed intermediate sanctions – a tax on excess benefit transactions – on individuals involved in transactions with tax-exempt entities that result in private benefit.[23] This legislation was largely a result of the tales of nonprofit fund abuse regularly reported in the press. However, it was also a way to give the IRS a way to penalize the individuals engaged in the transaction (rather than the charity alone) and provide an alternative to the revocation of the charity's tax-exempt status. Under the intermediate sanction rules, the individuals who benefit from the transaction and the board and committee members who approve the transfer of funds may be penalized for excess benefit transactions. Penalties are imposed jointly and severally and range from first-tier taxes of 10 to 25 percent to second-tier taxes of 200 percent.[24] Intermediate sanctions are a natural extension of the prohibition of private inurement central to nonprofit status. The Internal Revenue Code requires a tax-exempt entity to be organized and operated so that "no part of…[its] net earnings…inures to the benefit of any private shareholder or individual."[25] This ensures the charity benefits the public charitable purpose rather than individual interests.

Examples of private inurement include excessive compensation, property or asset sales, leases, loans, providing goods, services, and facilities, or the individual's use of an organizations assets. The private inurement doctrine does not prohibit transactions between the charity and individuals who control or are other wise close to it (other than private foundations, as noted above) but instead requires a test of reasonableness that makes a comparison of the transaction to a similar one engaged in by like organizations, acting with prudence in similar circumstances and may include an analysis of arm's length nature of the transaction, the costs, and similar elements.

3). <u>State law governing nonprofit directors.</u> Generally speaking, corporate nonprofit directors must reveal a conflict of interest in a transaction, but that conflict can be overcome if it is revealed and steps are taken to ensure the arms length nature of the transaction and its benefit to the charity. The Model Act allows transactions involving conflict of interest if (1) the conflict is revealed in advance and the board approves it with a determination it is fair to the charity or (2) prior to the transaction's conclusion the court or attorney general approves it.[26] While most states embrace this standard, the practitioner must check state law to determine state law on conflict of interest.

4) State law governing trustees. Trustees or directors of nonprofits organized in trust form must also comply with state trust laws. Under many state laws, transactions between a trustee and the trust are voidable unless the sale was authorized by the document, received prior approval from the court governing the trust, was approved by the beneficiaries, or was pursuant to a contract executed prior to the date the trustee assumed his responsibilities.[27]

c. The Duty of Obedience.[28] The duty of obedience requires the board member to ensure the charity carries out its mission as defined in its governing documents and that it complies with applicable laws. Typical breaches of this duty include failing to modify activities or services to comply with changes in the law, failing to oversee employees and agents, or changing the organization's purpose or activities to those outside the scope authorized by document or law. Directors of nonprofits who breach this duty may cause the nonprofit to lose its tax-exempt status if the charity begins to operate in a way that violates the intentions stated to the IRS, or that fails to serve the public good.

2. Practical Board Duties.[29] The ongoing duties of the board – its practical responsibilities – ensure effective nonprofit operation.

a. Establish Mission and Purpose. Mission statements are an important part of the corporate environment and are increasingly evident in the nonprofit sector. The board has a duty to clearly define the organization's charitable mission and purpose. This involves a clear statement of its intended goals and impact, a definition of its geographic reach, and prioritization of its objectives.

b. Select and Assess Executive Officer. The board's has the duty of hiring and evaluating the organization's chief executive officer. That chief executive officer in turn has the responsibility to hire and evaluate the organization's staff. (Volunteers that get involved in the hiring and firing of the charity's staff compromise the charity's ability to operate effectively.)

c. Ensure Continuity. The board ensures continuity in two primary ways: ongoing operational and strategic planning, and perpetuation of the governing body. The planning element is essential. The charity must have an annual operating plan (activities with goals and objectives), an accompanying annual budget, and a long-term strategic plan. Perpetuation of the nonprofit's governing body is generally directed by its charter and/or by-laws. Many boards are self-perpetuating, meaning the board members select its successors, while other selection processes depend upon individuals or organizations outside the charity's board. In either case, it is the board's responsibility to ensure new board members are put in place.

d. Exercise Oversight of Organizational Activities. Board members have oversight of the charity's mission-related activities and activities of its staff.

e. Public Relations. The board is the public face of the charity and should be sensitive to and provide oversight for the manner in which the charity is represented. This public image affects the charity's success in discharging its mission, and in raising funds for operation and capital support.

f. Ensure Accountability to Donors, the Public and the IRS. The board – through its oversight and governance function – has the responsibility to donors, the public, and the IRS to ensure accountability for use and expenditure of the organization's assets.

g. Manage Assets. The board is responsible for oversight of the management of the charity's assets. This includes ensuring safeguards are in place to prevent theft, embezzlement, or improper use of funds, safeguarding physical and financial assets through insurance and management policies, and establishing ethical standards ensuring agreements made with donors for the use of the funds will be honored.

III. Key Areas of Liability. Liability assessment begins with an understanding of the key areas of liability in board service. A recent article published in *The Exempt Organization Tax Review* by Marion R. Fremont-Smith and Andras Kosaras provides a sobering compilation of lawsuits and similar proceedings against charity directors and managers for civil and criminal wrongdoing for a period covering 1995-2002.[30] The survey data – gathered through a search on Lexis/Nexis – includes a count of the types of charitable entities involved, the individuals implicated, the outcomes, the dollar amount involved, and the entity conducting the review/prosecution and contains cautionary tales for the areas of risk detailed below.

A. Employee Management. Employee lawsuits are among the most commonly filed against nonprofit organizations, especially in the current recessionary economy. Nonprofits with employees must comply with all laws applicable to other corporations and businesses including:

- Employee Retirement Act of 1974[31] (ERISA)
- Title VII of the Civil Rights Act of 1964[32], as amended by the Civil Rights Act of 1991 (Title VII)
- Americans with Disabilities Act of 1990[33] (ADA)
- Equal Pay Act[34]
- Age Discrimination in Employment Act [35]of 1967 (ADEA)
- Occupational Safety and Health Administration Act (OSHA)[36]
- Fair Labor Standards Act[37] (FLSA)
- Consolidated Budget Reconciliation Act[38] (health benefit provisions) (COBRA)
- Family Medical Leave Act[39] (FMLA)

In addition to statutory claims, employees may also bring tort claims against a charity, such as defamation, or fraud and misrepresentation.

B. Third Party Liability. Nonprofit boards may have liability to individuals or organizations damaged as a result of the willful or wanton negligence of the board or the actions or activities of the charity. Damages may result from breach of the duty of care, conflict of interest, discrimination in employment (noted above), discrimination in the administration of programs and services, libel, slander, breach or contract, or other torts.

C. Investment Management. The charity's board is responsible for investment and management of its assets. While there is no federal standard for investment management (other than a private foundation's duty to manage the assets in a way so as to not jeopardize the foundation's ability to carry out it's tax-exempt status),[40] there are three bodies of state law that may govern the board's conduct. These include the Uniform Prudent Investor Act (established by the National Conference of Commissioners on Uniform State Laws), the Uniform Management of Institutional Funds Act (governing management of funds held for nonprofit purposes), and the *Restatement Third, Trusts (Prudent Investor Rule)* (establishing the standard for state trust law).[41]

1. The Uniform Prudent Investor Act.[42] The Uniform Prudent Investor Act (UPIA) was drafted and approved by the National

Conference of Commissioners on Uniform State Laws in 1994 and approved by the American Bar Association in February 1995. The Act is basically a codification of the *Restatement, Third, Trusts (Prudent Investor Rule)* recommended for adoption in all states to bring uniformity to trust investment law. The UPIA contains five major changes to the early standard of care (the prudent man rule) advanced by the *Restatement, Third, Trusts**:*** (1) The trustee's investment prudence is measure by a review of the entire portfolio rather than individual assets; (2) the trustee's primary role in investing is to balance risk and return; (3) there are no prohibited investments; (4) there is no absolute requirement that the trustee diversify investments (although diversification is an element of balancing risk and return); and (5) delegation of investment management is permitted. The law was intended to govern the conduct of trustees as well as other fiduciary relationships such as executors, conservators, and guardians. At least twenty-eight states have adopted the UPIA in some form.[43] It is interesting to note that in recommending the standards, the committee stated: "the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations."

2. <u>The Uniform Management of Institutional Funds Act.</u>[44] The Uniform Management of Institutional Funds Act (UMIFA) was drafted and recommended for enactment by the National Conference of Commissioners on Uniform State Laws in 1972. The uniform law was developed because nonprofit corporations and institutions had no specific directives governing investment conduct. Fearing that the only applicable standard was the prudent man rule, investments were structured conservatively using investments considered "safe" with a premium on production of income.[45] The Act applies to incorporated or unincorporated charitable organizations, including some governmental organizations; it specifically excludes trusts.[46] While UMIFA was recommended in 1972, well before the development of the *Restatement, Third, Trusts (Prudent Investor Rule)* and the UPIA, it contains many of the same prudent investor standards. Key elements of UMIFA are: (1) The nonprofit institution is allowed to use appreciation (realized and unrealized); directors and officers are urged to take a total return approach, looking at income and appreciation.; (2) Investments are not restricted to specific types of assets. The directors and officers are allowed to invest in an unlimited range of assets; (3) Delegation of investment responsibility is permitted. This duty may be delegated to employees or third party managers; (4) The standard of prudence is to be a standard of business care and

prudence, rather than the fiduciary standard set out in the prudent man rule; and (5) Restrictions imposed by donors can be released by the donor. If the donor is no longer alive, the institution can ask a court of competent jurisdiction to release the gift restrictions, so long as the court is not asked to convert an endowment to a non-endowment. The Act has now been adopted by forty-six states and the District of Columbia.[47]

3. *The Restatement, Third, Trusts (Prudent Investor Rule)*. *The Restatement Third, Trusts (Prudent Investor Rule)* sets the standard of conduct for most trustees. This standard is applicable to family foundations organized in trust form governed by trustees, or to those individuals or organizations that serve as trustees of pension plans, charitable remainder trusts, revocable trusts, or other trust documents. The original standard for a trustee's conduct, called the prudent man rule, was defined *in Harvard College v. Amory*.[48] There the court stated that: "All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probably income, as well as the probable safety of capital to be invested..."

   The old prudent man rule judged the fiduciary on results of individual investment decisions rather than the performance of the portfolio as a whole, it set rigid rules on issues such as diversification of assets, and it placed a premium on generation of income. Fiduciaries were held strictly accountable for violation of the rules, even where actions were taken with the approval of the governing document or at the encouragement of the beneficiary meaning that fiduciaries had no incentive to take chances.[49]

   In 1990, The American Law Institute recommended a new standard for trustees with the publication of the *Restatement, Third, Trusts (Prudent Investor Rule)*.[50] The new rule eliminates the rigidity created through court interpretation of the prudent man rule and allows the fiduciary flexibility and discretion in exercising judgment in investment matters.[51] Under the prudent investor rule, the fiduciary is judged on the decision making process employed at the time the investment decision is made, rather than on an after-the-fact analysis of performance. The emphasis on production of income and preservation of principal of the prudent man rule is replaced by a measurement of total return (total of income and capital appreciation) of the portfolio-looking at real return after inflation; this can also be stated as the duty to balanced risk and return. Finally, the trustee is allowed to delegate investment management so long as he monitors the process effectively.

While The *Restatement, Third, Trusts (Prudent Investor Rule)* is designed to govern the actions of trustee, the committee observed that the standards might also be appropriate for directors and officers of charitable corporations since "the duties of the members of the governing board of a charitable corporation are generally similar to the duties of the trustee of a charitable trust."[52]

d. <u>Comparing the Standards</u>**.** The heart of each of these standards of conduct is the prudent investor rule requiring the board exercise the care that "a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances" and that the fiduciary should "exercise reasonable care, skill and caution."[53] The rules governing the board's conduct in investment of foundation assets are summarized in Table 4:[54]

TABLE 4
COMPARISON OF VARIOUS INVESTMENT STANDARDS

	Prudent Man Rule	**Restatement Third, Trusts (Prudent Investor Rule)**	**Uniform Prudent Investor Rule**	**Uniform Management of Institutional Funds Act**
Priority on making assets income-producing	Yes	No	No	No
Investments restricted to specific assets	Yes, through legal list and court interpretation	No	No	No
Analysis of "prudence" made by examining performance of individual assets	Yes	No, entire portfolio	No, entire portfolio	Business standard of conduct, portfolio
Primary role of investment	Select asset that is safe, produces	Balance risk and return	Balance risk and return	Balance risk and return

manager	income			
Delegation of duties permitted	No	Yes	Yes	Yes
Can remove restrictions on income/principal distributions, restrictions on investment assets	No	No	No	Yes
Diversification required	Yes	No	No	No

D. Overseeing the Use and Disposition of Charitable Assets. Most of the reports of abuse describe private inurement – the use of charitable assets for personal benefit. Consider several recent examples:

- *Pennsylvania/Allegheny Health, Education, and Research Foundation*. The Foundation declared bankruptcy in 1998. It's executive, Sherif S. Abdelhak, was paid an annual salary of $1 million. He was sentenced in 2002 to spend 23 months in prison for using foundation assets to meet operating expenses of the health system.[55]
- *Hawaii/Kamehameha Schools (Estate of Bernice Pauahi Bishop*). Ms. Bishop's estate created a charitable trust to run two private schools for Hawaiian citizens, with preference given to natural Hawaiian students. The testator – a descendant of King Kamehameha – funded the trust with approximately 10% of the land in Hawaii. (At the time of the litigation in the 1990s, estimates of the trust's asset value ranged from $6 to $10 billion). The five trustees were paid an annual salary in excess of $900,000. The state Attorney General got involved when stories of fraud, mismanagement, and personal benefit were published, and eventually asked the probate judge to remove the trustees. The probate judge removed four of the five trustees (and the fifth resigned) in the face of the IRS threat to revoke the school's tax-exempt status.[56]
- *Mississippi/Sta-Home Health Agencies of Carthage, Greenwood, and Jackson, Mississippi*. The IRS found this charitable home health care agency had sold the nonprofit assets to for profit companies at a discounted price. The charity was ordered to repay $5.2 million (plus penalties in excess of $1 million).[57]

E. Compliance with State Law. State law defines the duties of the individual director, establishes organizational compliance standards, and creates a reporting and oversight mechanism through the state attorney general's office.

1. The State Attorneys General. Charities required to file tax returns must file a copy of their 990 or 990-PF with the attorney general in the states in which they operate. In addition, most state attorneys general are charged by law with the responsibility of representing the charitable interests in the state. Where the Attorney General finds malfeasance or misfeasance remedies include

   - Correcting the wrong by changing the form, by-laws, or policies of the charity to ensure compliance going forward, or ordering a court with jurisdiction to do so;
   - Removing the board member or members responsible for the wrong; and/or
   - Imposing criminal sanctions on the individuals involved in the wrongdoing.

   Some states, such as New York, have active Attorneys General while other states experience little oversight or activity. If reports of charitable abuse continue to rise, it is likely all states will see an increase in monitoring.

2. Audit. Many states require nonprofits to have an audit completed if revenues exceed a specific dollar threshold. They might also be required to have an independent audit if they receive government grants in excess of certain amounts, participate in the Combined Federal Campaign at certain levels, or receive grants from private foundations requiring an audit as a part of the grant agreement.

3. Collect and Submit Sales Tax. The charity may be engaged in sales of merchandise to the public, and therefore subject to sales taxes. These must be collected and remitted to the appropriate governing bodies.

4. Pay Property Tax. If the charity owns real property, it must either seek an exemption from that tax or remit it.

5. Register in States Where it Solicits Funds. Most states have charitable solicitation laws requiring nonprofits soliciting in those states to register. The charity should seek advice on those states in which it solicits, and follow through with registration and annual filings.

F. Compliance with Federal Law.

1. IRS Filings. The IRS is the primary nonprofit gatekeeper. Charities are required to file Form 1023 seeking tax-exempt status, and public charities (other than churches, which are exempt) with income of $25,000 or more are required to file an annual informational return (the 990 or 990-PF) reporting the organization's activities, distributions, payments to individuals, other charities, and corporations, financial assets, governing board, staff, and relationships.[58] In addition, charities may file many other returns, including Form 4720 (for excise taxes), and W-2s and W-3's (employee returns), 990-T (for unrelated business tax), and others as required.

2. Make Forms 990 (990-PF) and 1023 Available to the Public. Charities are required to make public disclosure of their activities to the public by providing the last three year's tax filings and a copy of their Form 1023, Application for Recognition of Exemption.[59]

3. Employee Obligations. As noted above in III (A), nonprofits with employees are required to comply with the following laws: ERISA, Title VII, EPA, ADEA, OSHA, FLSA, FICA, COBRA, and FMLA. In addition, the charity must withhold taxes and submit those to the federal, state, and local governments.

4. Substantiation of Gifts. Charities are required to substantiate gifts to donors that exceed $250. This is required of all charities, including private foundations.

5. Comply With Federal Postal Laws. Many charities send bulk mail; this requires a permitting process with the U.S. Postal Service, and adherence to the guidelines for bulk mail.

G. Account for Funds. Directors are ultimately responsible for oversight of the use of the charity's funds (to ensure funds are used for the charity's mission and public benefit) and compliance with donors' instructions. Recent lawsuits on the latter point have made it clear that donors (and family members) may raise objections when charities accept funds for a specific purpose and fail to comply with gift conditions. While most state laws give the Attorney General (rather than the donor or the general public) the right to enforce such terms, courts in recent years have relented, allowing the donor or donor's family to enforce restrictions.[60]

1. Misuse of Funds. Many of the most visible cautionary tales relating to charitable misdeeds have had to do with fund accountability and lack of board oversight. Consider these examples.

    a. United Way of America/William Aramony. William Aramony, the chief executive officer of United Way of America, was fired in 1992, convicted in 1995, and sentenced to seven years in federal prison for charges that included conspiracy to defraud, mail fraud, wire fraud, engaging in monetary transactions in unlawful activity and filing false tax returns. Some of the more public elements of the scandal included accusations he had used United Way funds to purchase first class airline tickets, hire limousines and chauffeurs, and secure jobs for family and friends. The national board structure was dramatically reorganized after the debacle to help build relationships with local United Ways and restore public confidence.

    b. United Way of the National Capital Area.[61] In the summer of 2003, newspapers in the Washington, DC area reported accusations that Oral Suer, a 27-year employee of United Way of the national Capital Area and its chief executive at the time of the reports, had received at least $1.6 million in inappropriate benefits or payments. These included salary in excess of approved amounts, the failure to return unused advances, unauthorized personal charges to United Way accounts, and other personal benefits. These violations were discovered in an audit of the charity's records. Forty-five board members responsible for governance missed the payments (although two board members may have known of the amounts owed to United Way by Mr. Suer but did not share the information with other directors).

    c. The Mid-America Foundation. The Mid-America Foundation of Scottsdale, Arizona was involved in a similar disaster. The Mid-America Foundation aggressively pursued charitable gift annuities from donors in Arizona and Florida by paying financial planners a commission to market those annuities.[62] In October 2001, the executive director of the foundation, wrote donors to notify them they would no longer receive annuity payments because Mid-America had "inadequate assets"[63] (Several months earlier, the foundation had represented to planners that it had assets of $42 million.) The foundation then turned off its telephones, shut down its web site, and left town.

The foundation's executive director had run into regulatory problems before; Robert R. Dillie had had insurance licenses denied or revoked in Wisconsin, Arizona, Colorado and Illinois. In February 2003, Mr. Dillie was indicted by a federal grand jury on 193 counts of wire fraud and money laundering in connection with the Mid-America fraud.[64] The indictment alleged he had diverted funds raised through gift annuities for person usual, including gambling, the purchase of a home, the purchase of a car and cash. The U.S. Securities and Exchange Commission also filed suit again Mr. Dillie, alleging he issued phony statements and diverted foundation funds to personal use.[65]

d. The Baptist Foundation of Arizona. The Baptist Foundation of Arizona, an agency of the Arizona Southern Baptist Convention, invested assets for the 400 churches and missions comprising the Arizona Southern Baptist Convention, and issued charitable gift annuities to its donors. A large percentage of the invested funds (including the gift annuity pools) were invested in high-risk real estate transactions, and a series of loans to a director and former directors who owned several of the 63 for profit and not for profit subsidiaries of the Foundation.[66] According to the testimony, the Foundation moved many of the real estate investments to subsidiaries so that the loans made to these subsidiaries could be recorded as assets, even when the value of the real estate securing the loans dropped below the outstanding balances.[67] The Baptist Foundation of Arizona filed for bankruptcy in September 1999, defaulting on thousands of obligations to donors and investors.

The fallout was dramatic. Several executives of the Foundation pled guilty to fraud and related charges, agreeing to lesser sentences in exchange for cooperation. Five remaining executives were indicted, and are awaiting trial. Arthur Anderson – the accounting firm that audited the Baptist Foundation of

Arizona and its subsidiaries – agreed to pay $217 million to settle three lawsuits resulting from the default and bankruptcy. The two Andersen accountants responsible for auditing the foundation were required to give up their licenses to practice in Arizona as part of the deal. Approximately 70 percent of the amount defrauded is expected to be returned to donors and investors.[68]

2. Enforcing Donor Intent. Upholding donor intent is a matter of ethics under many state laws since donors may not have the right to file suit if the funds are not used as directed by the donor. For example, the Carl H. Herzog Foundation filed to recover a portion of a $250,000 grant made to the University of Bridgeport designated for medical education scholarships claiming the University had used the funds for another purpose. The court found the donors had no standing to sue. The court noted the donors would have had an actionable claim if the donor had included language had been in the gift agreement granting them the right to enforce the restrictions through litigation. (The court also observed the right to enforce the use of the funds might have represented enough control over the contributed funds to deny them a deduction for the gift.)[69]

   In some states, however, courts have allowed donors to pursue such lawsuits. For example, a July 2003 lawsuit filed in Amarillo, Texas by the Estate of Sybil B. Harrington and the Amarillo Area Foundation (appointed by Ms. Harrington to oversee the use of the funds) sought the return of $5 million from the Metropolitan Opera in New York. Ms. Harrington had created a significant endowment with the Metropolitan Opera to fund traditional opera, and the suit alleged they had applied the funds for purposes outside that scope.[70] The lawsuit was allowed to proceed.

   In another example, R. Brinkley Smithers gave $10 million to St. Luke's-Roosevelt Hospital Center in New York to create an alcoholism research and treatment facility over a period extending from 1971 to 1983. After his death in 1998, his widow sued the hospital alleging it had not lived up to the terms of the agreement with Mr. Smithers. The hospital settled the lawsuit in July 2003, agreeing to transfer $6 million to another nonprofit to establish a freestanding alcohol treatment center, and to restore $15 million to the endowment. In addition, the Surrogate Court will award her reasonable fees and expenses, although the amount has not yet been determined.[71]

IV. Managing the Risk. Both the charity and its governing body need protection against risk. Whether the charity has thousands or millions, the governing board has a fiduciary duty to protect those assets. In addition to the charity's assets, the individuals participating in governance or management may have substantial personal assets at risk. Therefore, both the charity and its directors must manage risk. Risk can be managed in four ways: statutory protection, insurance, policies and procedures, and proper operation.

A. The Concept of Liability. It is important – especially when discussing the director's liability – to distinguish the risk to the charity and the risk to the individual working for or on behalf of the charity.

1. The Charity's Liability.

a. The Doctrine of Charitable Immunity. The doctrine of charitable immunity derived from common law and barred injured parties from suing charities on the theory that charities were engaged in public work (and their funds should be devoted to public work, not to injured individuals). Volunteers, however, were not generally covered under this protective doctrine. In some states the doctrine of charitable immunity was codified, while in others it was imposed by case law.

b. The Statutory Changes and Lawsuits of the 1980's and 1990's. The charitable immunity doctrine was slowly abandoned beginning in the 1940s and is now almost completely eliminated[72] meaning that charities are now held responsible for their actions, even at the risk of putting the charity out of business. Lawsuits against charities, and increasingly against its directors and officers, and become more numerous in the 1980s, 1990s, and 2000s. The stakes are rising as well, with the onslaught of litigation against the Catholic Church, the onset of charitable Ponzi schemes as practiced by the New Era Foundation and Mid-America Foundation, and the fraud and mismanagement (affecting hundreds of annuitants) of the Arizona Baptist Foundation. The continuing reports of personal inurement involving United Way of America, local United Ways, Multiple Sclerosis Association, and others have also created a riskier environment for charities.[73]

2. The Volunteer's Liability. For many years, individuals relied upon their homeowner's policies for protection for volunteer

liability. Federal law, and most state law, now provides protection for some acts and failure to act. However, umbrella provisions on homeowner's policies – discussed in the next section – vary dramatically by policy and rarely cover all potential liability.

B. Statutory Protection. There is both federal and state statutory protection for volunteers (generally defined as individuals serving without compensation, or for de minimus compensation, and acting within the scope of their duties).

1. Federal Volunteer Protection Act. The goal of the Volunteer Protection Act of 1997[74] was to increase and protect volunteerism. The act covers uncompensated directors, officers, trustees, and direct service volunteers who perform services for a 501(c)(3) organization or any organization established for charitable, civic, educational, religious, welfare, or health purposes (other than an organization involved in hate crimes) or for the state.[75] The individual is considered a volunteer if he or she receives compensation or items of value of $500 or less annually; reimbursement of actual expenses is permitted and does not fall within the $500 limit.[76] Volunteers are exempted from liability for harm for an act or omission where:

   - The volunteer is acting within the scope of his or her duties;
   - If appropriate or required, the volunteer is licensed, certified, or authorized to perform the activity;
   - The act or omission was not willful or criminal misconduct, gross negligence, reckless misconduct, or a flagrant indifference to the safety or rights of the individual that is harmed; and
   - The harm was not caused by the volunteer operating a motor vehicle requiring a license or insurance.[77]

2. State Volunteer Protection Acts. Most states now have some form of volunteer protection, most patterned on the federal statutes. The details of state law are important, however, in defining insurance needed to fill the gaps. In addition, volunteers are always exposed to the interpretation of these laws by state courts.[78] There is an important distinction between immunity from suit, limited liability (the individual is liable for damages only above certain amounts, or if he has arranged coverage of certain amounts or met other requirements), and indemnification (the individual is entitled to reimbursement from the nonprofit in the even he or she is found liable or incurs costs

defending the action). Look for these distinctions in state statutes and in personal and nonprofit insurance policies providing coverage.

C. Managing Risk Through Insurance. Charities generally manage risk through self-insuring or purchasing insurance, with the latter being the more common.

1. The Role of Insurance. An analysis of a charity's insurance needs must begin with a clear focus on the type of protection needed. While most nonprofits focus on coverage for "acts and assets", every charity is unique. Some engage in direct delivery of services, while others simply fund other service providers. A charity engaged in providing day care, for example, might have a higher risk level than a charity that provides music scholarships to grade school students. Museums or libraries have large quantities of personal property assets that are extremely valuable. Private universities have enormous investments in a physical plant. Charities using volunteers to deliver meals over thousands of square miles have yet a different type of liability exposure.

   Most charities purchase general liability, commercial automobile, commercial property, and directors & officers insurance to protect:

   - The charity's building and property;
   - Its financial assets – including operating cash, revenue from services or sales, and endowment assets;
   - Its personal property;
   - The acts or failure to act of its directors;
   - The acts or failure to act of its trustees;
   - The acts or failure to act of its officers and staff (including third party contractors working on behalf of the charity); and
   - The acts or failure to act of its volunteers.

   The charity should list the risks that are most expensive and most probable. Armed with that list, it can do a more effective job purchasing the appropriate coverage.

2. The Role of Indemnification. Indemnification is the restoration of an entity or individual for a loss through coverage or reimbursement of the costs associated with that loss. These costs may involve legal expenses or assessed damages.

a. Variances in State Law. The Model Act [79] and most state's nonprofit corporation laws allow a charity to indemnify its board, trustees, and officers for any personal costs related to their service. These expenses may include the cost of counsel, litigation, and damages assessed against them for acting within the scope of their duties (non-compensatory damages). Some allow indemnification for intentional willful or reckless acts (or failure to act), covering the damages and excise taxes imposed on the individual (compensatory damages).

b. The Impact of the Charity's Governing Document. If state law requires indemnification, the charity is obligated to follow the law, providing that coverage to the extent required. The charity can always make a decision to provide greater coverage than required by law, unless such covered is prohibited by state or federal laws (such as the self-dealing rules or intermediate sanctions[80]). If indemnification is permitted but not required, the charity must make a decision about the extent to which it will indemnify its directors, trustees, officers, employees and volunteers. It must then make a decision about how to meet that obligation if called upon by creating financial reserves, purchasing D & O insurance for the organization, or some other method.

c. Nonprofit Insurance for Directors, Officers, Employees and Volunteers. Insurance is increasingly expensive as lawsuits against nonprofits have become more common, and the damages wreaked by nonprofits through fraud, mismanagement, and Ponzi Schemes reach new levels. Therefore, it's important to understand the unique features of each type of coverage so that the charity purchases the full coverage needed but does not waste money on unnecessary protection.

   i. General Liability. General liability insurance provides broad protection for the nonprofit's operations, contracts, and accidents on its premises. This insurance covers damages to the charity's property and liability for personal injury it causes. It does not, however, cover property of others in the charity's custody. This insurance is critical to organizations actively engaged in programs that actively

ii. Directors and Officers Insurance. D & O insurance is designed to protect directors against claims resulting from breach of duty, errors in judgment, omissions, or other wrongful acts, (although it is not designed to protect directors who engaged in willful and wanton acts in violation of the duty of a director). There is no "standard" D & O coverage – the charity should be careful to specify the coverage needed and make sure that the critical elements are included.[81] Coverage usually included in D & O policies includes unintentional violations of the law, fines and penalties in third party suits, punitive damages in third party suits, and expenses in defending actions.

The following acts may not be automatically covered by the D & O policy: intentional violations of the law, bodily or property injury, professional liability, punitive damages, torts, suits or legal actions of one director against another, and employment violations.

iii. Errors and Omissions. A charity may face claims for professional negligence if it provides professional and/or paraprofessional services (for example, nonprofit hospitals, legal aid clinics, social service organizations providing counseling) and may require Errors & Omissions or similar coverage. If this coverage is required, read the policy limitations carefully. Some hospital policies exclude specific types of claims (such as medical malpractice, or proscribing medication), while covering others (such as administering medication). In non-medical fields, as well, the charity may have a choice of a policy covering specific professional or paraprofessional services or another covering all professional services.

iv. Personal Umbrella. Most individuals serving on charitable boards should consider expanding their personal umbrella coverage under a homeowner's policy.

3. Private Inurement/Self-dealing Issues in Providing Insurance to Directors. Nonprofits purchase D & O insurance to protect their board and volunteers, to attract qualified volunteers to the jobs, and to ensure the charity's ability to carry out its tax-exempt purpose. The IRS, however, took the position that at least a portion of the D & O premium represented a personal benefit to the covered volunteer and should be reported as compensation.[82] The issue of personal benefit is important because of the self-dealing rules for private foundations, and the intermediate sanctions for all charities. For many years, charities were required to allocate a portion of the premium as compensation. However, in 1991, the Treasury Department issued proposed regulations treating D & O premiums and indemnification payments to individuals performing services for charities as "working condition fringe" benefits under IRC § 132;[83] these regulations became final on December 30, 1992. The final regulations made it clear that volunteers were considered an employee for this purpose.

   The 1992 regulations did not address the self-dealing issue for private foundations (the final regulations indicated this would be addressed separately). That resolution came with final Treasury Regulations issued in 1995 provided that private foundations providing indemnification or insurance to cover liability for a foundation manager would not be self-dealing.[84]

D. Managing Risk Through Policies and Procedures. Directors may also manage risk by ensuring the charity has appropriate policies and procedures for its high-risk activities.

1. Annual Risk Assessment. Every charity will have exposure to varying types of risk depending upon the services they provide, the populations they serve, and the skills/risks associated with those services and activities. The charity should make an annual risk assessment by reviewing its internal and external activities and exposure to list those activities creating greatest risk. It should then ensure that policies and procedures are in place to manage those risks, reviewing those policies annually and revising them as necessary. (Some of the most common internal policies are discussed in the following paragraphs.) Using an annual checklist to review basic functions is also a way to manage liability; a sample annual checklist is attached at Appendix B.

2. Gift Acceptance Policies. Most charities encourage and accept gifts from donors. If the charity encourages gifts of non-cash assets (such as public and private securities, business interests, real estate, tangible personal property, intellectual property, retirement benefits, insurance benefits, bequests, and split interest trusts), it is important to have policies governing acceptance of those gifts.[85]

3. Investment Management. The director's responsibilities for investment management were discussed in some detail above. It is essential the charity have, and annually review, investment management policies setting out its perspective on balancing risk and return, spending policy, asset allocation, and return objectives. This is especially important when a third party firm is providing investment management services and the charity is responsible for providing direction and oversight.

4. Financial Management. The charity should have strong internal policies and controls for money movement (receipts, transfers and expenditures), asset purchases and sales, audit trails, and regular review of transactions.

5. Donor/Data Management. Charities should adopt standards for confidentiality of records, ethical treatment of donor data, and donor response (thank you and substantiation) standards. In addition, the charity should define donor information fields, the length of time the data will be maintained, and designate persons responsible for complying with federal substantiation and reporting.

E. Managing Risk Through Proper Operation. Most of the statutory and practical duties of board management are discharged through an active, properly operating governance structure.

1. Board Structure. Board structure – its size, selection, and organization – is an important element of managing a charity's risk. The most effective boards will have a board selection process designed to install directors qualified to meet and perform governance duties.

a. Size. Nonprofit boards vary in size depending on the form of the charity, state requirements (for example, most states have a proscribed minimum number of nonprofit board members), scope, and duties. The most recent survey by BoardSource[86] (former, the National

Center for Nonprofit Boards) reports that most board have between 11 and 25 members.

b. <u>Selection</u>. Selection of board members is governed by the charity's Articles of Incorporation (or trust document) and by-laws, which proscribe both the method of selecting and replacing board members as well as any specific requirements. For example, a private Baptist University may require that its board members be active members of the denomination, or a community foundation may direct that its board members are nominated or appointed by various elements of the community (such as the judicial system, the educational system, the human services community, etc.)

Board members should be selected for what they bring to the governance and operation of the charity. This requires some thought be given to the skills needed on the board, and the skills represented by current members. Moving beyond obvious professional or experiential skills, a good board member might have:

- An understanding of or visibility in the population served by the charity;
- An interest in the charity's work, and in nonprofit work in general;
- A strong set of personal values, and integrity;.
- An ability to think strategically;
- An ability to think tactically;
- An ability to work as a team;
- The propensity to ask thoughtful questions and makes careful decisions;
- Access to segments of the community that will support the charity;
- Potential as a donor;
- Experience with other successful charities;
- The time to meet board commitments; and
- Visibility and respect in the community, adding credibility to the charity.

c. <u>Terms</u>. Terms of office are governed by the charity's by-laws, and on occasion, by the Articles of Incorporation. Board terms should be structured to allow and encourage transition on the charity's board. For example, the by-laws may provide that directors serve three-year terms, but those directors may not serve more than two consecutive terms. In this example, a board member might serve for six years, take a year off, and return for another six-year term.

Rotation serves several purposes.

- Term limits allow the circulation of new people, and with them, new ideas and priorities. This may be especially important when making a constant review of the charity's practices that might be more easily identified by a new board member than someone who has grown up with the policies.
- Term limits allow those without a real interest a graceful way to remove themselves from service.
- Term limits allow board members to focus during the board term rest during the break, and to renew enthusiasm when returning to the board.
- New members add to the dynamics of the decision-making. Some individuals dominate a process, and a rotation off of the dominators, with the addition of new ideas, may result in a more lively distribution and management process.

d. Officers. Key non-staff officers of a charity include its Chief Volunteer Officer (chair, president) who provides leadership, chairs meetings, assigns committees, charges committees, serves ex officio on committees, provides primary liaison with staff, ensures regular financial reporting, ensures ongoing strategic planning and budgeting, and guides the review of the chief executive officer's performance; the Vice-Chair, who stands in for the Chief Volunteer Officer when he or she is not available, and takes on other duties assigned by the by-laws or the Chief Volunteer Officer; the Secretary, who maintains the records of meetings, committees, and official actions taken by the board; and the Treasurer, who oversees the finances and budgeting of the charity, oversees the audit, ensures adequate resources, oversees investments, and reports financial matters to the board.

2. Meetings. State law generally proscribes a minimum number of annual meetings for the corporation; the organization's documents may proscribe an additional number. These meetings are critical to the dissemination of information, organizational decision-making, and general accountability. It is critical that directors are active and attend as many meetings as possible. If members do not participate in meeting, it is difficult (or impossible) to meet the duty of care.

3. Committee Work. Most of the real work of boards takes place in committees. Standing committees generally include an Executive Committee (to make binding decisions between regular board meetings and to oversee governance), Finance Committee, Development/Fundraising Committee, and a Program Committee (related to oversight of the work of the charity). After Sarbanes-Oxley, and in response to the continuing reports of charitable mismanagement, the nonprofit should also consider a standing Audit Committee.[87] Directors assigned to committee work should take that responsibility seriously and attend as many meetings as possible.

4. Reporting. The charity should place value in reporting to its board. Where the charity does not report, board members should request the information needed to monitor the charity's activities, finances, services, impact, and soundness. If the charity is not willing to provide adequate information, the director should likely resign.

5. Compensation. Most directors work without compensation. However, there are instances in which special expertise is required, excessive time is required, or enormous responsibilities are placed on board members. Compensation for directors is not prohibited; however, under all standards of loyalty, self-dealing rules, and private inurement standards, that compensation must be reasonable for the services performed, and the work must be designed to further the charitable purposes of the entity.

V. Final Thoughts. Nonprofit board members serve a critical role in enabling philanthropy. The private sector is dependent upon the expertise, involvement, contributions, and advice provided by the boards of over 800,000 charities to fill gaps not met by government services on a national, state, and local level. These board members, however, assume a position of public trust and responsibility, and face increasing exposure to liability if they fail to meet their fiduciary duties to manage the assets of the charities they govern.

The advisor's role is to advise clients on responsibilities of nonprofit management, help them review the potential liability for service, and guide them is securing protection for that service. The advisor should assess the liability, review policies, procedures, and protection in place, and then guide the client in obtaining the necessary protection.

APPENDIX A
SAMPLE BOARD MEMBER SERVICE AND CONFLICT OF INTEREST STATEMENT

Note: Conflict of interest policies should be modified to address the particular needs of the non-profit institution. The officers, staff and board members of the organization should adopt those policies.

As a member of the Board of Directors of ***XYZ Charity***, I, __________________, am committed to ***XYZ Charity's*** goal to establish and maintain the highest level of public confidence in its accountability. I have personally committed to follow the standards set out below, which are a part of ***XYZ Charity's*** conflict of interest policies:

- I will attend at least 75% of the meetings of the board and participate in assigned committees.
- I will stay informed about the activities of the organization, asking questions and requesting additional information when needed to exercise oversight and make decisions on behalf of the organization.
- I will abide by the terms of the charity's operating documents, all federal laws, the laws of the state of _______, and local laws.
- I will conduct my activities with the Board of Directors of ***XYZ Charity*** so that I do not advance or protect my own interests, or the private interests of others with whom I have a relationship, in a way that is detrimental to the interests of or to the fundamental mission of ***XYZ Charity***.
- In every instance in which I represent the ***XYZ Charity***, I will conduct my activities in a manner to best promote the interests of ***XYZ Charity***.
- In all matters that come before the Board of Directors for a vote that may favorably impact my own financial interests, or the private interests of others with whom I have a financial relationship, I will reveal that relationship and abstain from a vote in the matter.
- When a conflict of interest arises, or when a potential conflict of interest emerges, I will disclose that conflict or potential conflict to the Director of ***XYZ Charity*** or to the Chairman of its Board of Directors and seek a resolution of that issue.

Entered into on this the ______ day of _______, 200_.

____
Member, Board of Directors

APPENDIX B
CHECKLISTS FOR BOARD MEMBERS

I. Personal Checklist Before You Join the Board (Pre-director Review)

___ Ask for a written list of board duties and meeting dates. How many meetings are you expected to attend? Does the organization provide board training? How many committees will you be expected to serve on, and how often do those committees meet?

___ Determine why you were asked to join the board. Do you have specific expertise, fundraising ability, or other specific talents that make you an attractive board member?

___ Ask for a copy of the charity's current strategic plan.

___ Review the organization's last two annual reports. How clearly is the financial information presented? How well does the report communicate the charity's mission, services and use of funds?

___ Check Guidestar (www.guidstar.org) to review the charity's latest Form 990. Does this information correlate with information presented in the annual report? What is the relationship of the charity's expense to its expenditures on programs? How do staff salaries compare to national norms?

___ Review the current list of board members. Contact several to determine if the charity believes in an active board involvement (or are board members expected to show up, vote, and not get involved) and if the board and staff have a strong, open, working relationship.

___ Ask the chief executive officer (or CFO) to share a written description of its board indemnification policy, D & O policy coverage and limits, and other insurance covering the charity and its volunteers.

___ Ask how the organization funds its operations. Does it rely on government grants, individual donations, fees for services, membership fees, or other revenue?

___ Ask how the organization manages reserves. If it has an endowment, ask to see the most recent investment returns.

II. Personal Checklist for Board Service (Annual Evaluation)

___ Did you attend the board's annual workshop and/or training session?

___ Did you attend at least 80% of the scheduled board meetings?

___ Did you review the minutes of each meeting you attend to ensure the board's actions were correctly reflected?

___ Did you review the minutes of meetings you did not attend to learn the actions taken by the board in your absence?

___ Did you participate in key decisions made by the board, asking questions, listening to the opinions of others, and voting only when you had the facts and professional input needed to make a decision?

___ Did you review the charity's budget and financial statements on a monthly or quarterly basis, asking questions to clarify items you did not understand? Did you raise concerns when those figures varied from those projected and approved?

___ Did you review the charity's audited financial statements? Were those prepared in a timely manner? Did you review the accompanying management letter and address all items raised as a concern?

III. Board Annual Checklist

___ Has every board member been asked to sign a conflict of interest statement, agreeing to put the interests of the charity above personal interests and to reveal any conflicts of interests in matters put before the board?

___ Has the board evaluated the performance of the charity's CEO? Was this performance review in writing? If there were materials issues or questions, were these shared with the board?

___ Is the board satisfied with the performance of staff? Did the board review the salary levels for the chief executive officers and staff, comparing those to salaries of comparable nonprofits?

___ Does the board have a current strategic plan; if not, are there plans to engage in this long-term planning process?

___ Has the organization made its financial statements available to the board? Has the finance committee reviewed and approved these statements?

___ Is the charity operating in accordance with its budget and with its available revenues and assets?

___ Has the board review (annual review) the charity's financial policies, investment management policies, gift acceptance policies, and donor data polices?

___ Did the finance committee, and board, review the endowment's investment returns, comparing those returns to investment policy guidelines?

___ Do the organization's fundraisers operate effectively and in accordance with ethical standards?

___ Did staff share statistics on the charity's performance in serving the public good? For example, did it provide data on the number of individuals served, or some other measure of its programmatic effectiveness?

___ Has the organization filed all tax returns with the IRS? Has it filed a copy of its 990 with the state Attorney General?

___ Did the charity have an audit performed by an outside firm? Has the board received those results? Were any exceptions noted on the management letter?

___ Did the charity perform an annual risk assessment? Does the charity have adequate insurance coverage based on that assessment? Does the charity have policies in place ensuring claims will be reported on a timely basis? Was director coverage reviewed and shared with the board?

___ Were there lawsuits or other liabilities incurred by the charity during the year? How did the board learn of these issues?

___ Does the charity have a strong nominating committee with a process designed to recruit the most effective board members? Did the committee meet and nominate new directors successfully?

Endnotes

[1] Kathryn W. Miree is president of Kathryn W. Miree & Associates, Inc., a consulting firm that works with nonprofits (public and private) and their boards to assess development efforts and implement planned giving programs. She received her undergraduate degree from Emory University and Juris Doctor from The University of Alabama School of Law. She is the author of *Professional Advisors' Guide to Planned Giving*, 2004 Edition (Aspen Publishers 2003) and co-author of *Family Foundation Handbook* (Aspen Publishers 2001).
[2] American Association of Fundraising Counsel Trust for Philanthropy *Giving USA* (2003). *Giving USA* can be ordered from AAFRC Trust for Philanthropy by calling 1-888-544-8464, or by downloading a form at <wwwgivingusa.org>.
[3] These figures represent published index returns generally available through the Internet or investment houses.
[4] Index returns through the end of the third quarter were provided courtesy of Merrill Lynch.
[5] 2002 IRS Data Book (published March 2003) <www.irs.gov>.
[6] Corporations creating headlines prompting Congressional action included (among others) WorldCom, Enron, and Global Crossing.
[7] Public Law No. 107-204 (July 30, 2002).
[8] An excellent article on the Sarbanes-Oxley Act and the implications or lessons for nonprofit management can be found at <www.guidestar.org/news/newsletter/sarbanes_oxley.jsp>.
[9] *Scott on Trusts*, § 201.
[10] IRC § 509(a).
[11] IRC §§ 4941 (self dealing), 4946 (disqualified persons), 4944 (jeopardizing investments), 4945 (taxable expenditures).
[12] A copy of the Revised Model Nonprofit Corporation Act (1987) can be downloaded at <http://www.muridae.com/nporegulation/documents/model_npo_corp_act.html> or found at <http://www.paperglyphs.com/nporegulation/documents/model_npo_corp_act.html>.
[13] The Model Act § 8.30(a).
[14] *Restatement, Second, Trusts* § 174. Note, this standard did not change in the *Restatement, Third, Trusts*.
[15] Many state laws and nonprofit corporation by-laws allow attendance by telephone or in other electronic format.
[16] The Business Judgment Rule, or Best Judgment Rule.
[17] The Model Act § 8.30(c).
[18] The Model Act § 8.30(b).
[19] IRC § 4941.
[20] Defined in IRC § 4946.
[21] Some product sales are permitted in limited circumstances.
[22] IRC § 4958.
[23] *Supra*.
[24] IRC § 4958(a), (b).
[25] IRC § 501(c)(3).
[26] The Model Act § 8.31(b). Conflicts with mutual benefit companies can be found at § 8.31(c).
[27] For example, see the *Arizona Revised Statutes* at § 14-10802 (Duty of Loyalty).
[28] The duty of obedience is not addressed in The Model Act; however, it is a clearly established duty under the common law.
[29] BoardSource, formerly the National Center for Nonprofit Boards, publishes an excellent brochure on this subject entitled "Ten Basic Responsibilities of Nonprofit Boards" (publication #401). This and other publications on board governance, can be ordered at <www.boardsource.org>.
[30] Fremont-Smith, Marion R. and Andras Kosaras, "Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002," 42 Exempt Org. Tax Review 25 (2003).
[31] 29 U.S.C. §§ 1001, *et. seq*.
[32] 42 U.S.C. §§ 2000e, *et. seq.*
[33] 42 U.S.C. §§ 1201, *et seq*.
[34] 29 U.S.C. § 206.
[35] 29 U.S.C. §§ 621, *et. seq.*

[36] Public Law 91-595, 84 Stat. 1590 (December 29, 1970).
[37] 29 U.S. C. §§ 201, *et. seq.*
[38] Public Law 99-272 (April 7, 1986).
[39] 29 U.S.C. §§ 2601, *et. seq.*
[40] IRC § 4944.
[41] The Uniform Management of Institutional Funds Act incorporates the same principles and was designed to govern funds permanently set aside for charitable purposes. UMIFA allows expanded investment options beyond the legal list, gives the fiduciary the ability to hold contributed assets, or sell them, allows the fiduciary to pool investments in a common fund, pool, or investment partnership, and allows the fiduciary to delegate investment management to independent advisors. Considerations in making investments should include an analysis of long and short term needs of the nonprofit in carrying out its purpose, current financial needs, anticipated financial needs, expected total return on investments, and general economic conditions.
[42]The Uniform Prudent Investor Act is available through the National Conference of Commissioners on Uniform State Laws at <http://www.nccusl.org/nccusl/DesktopDefault.aspx>.
[43] Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Hawaii, Idaho, Illinois, Maine, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Jersey, New Mexico, New York, North Dakota, Oklahoma, Oregon, Rhode Island, Utah, Vermont, Virginia, Washington, West Virginia. Also, some states such as Alabama have adopted the prudent investor rule, but did so before 1994 when UPIA was promulgated.
[44] The Uniform Management of Institutional Funds Act is available through the National Conference of Commissioners on Uniform State Laws at <http://www.nccusl.org/nccusl/DesktopDefault.aspx>.
[45] Uniform Management of Institutional Funds Act, National Conference of Commissioners on Uniform State Laws (1972), prefatory note.
[46] Uniform Management of Institutional Funds Act, Section 1 (1) and comments.
[47] Alabama, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.
[48] *Harvard College v. Amory*, 9 Pick. (26 Mass.) 466, 461, 26 Mass. 446, 461 (1830).
[49] See *First Alabama Bank of Huntsville v. Spragins*, 475 So. 2d 512 (Ala. 1985), *on rehearing*, 515 So. 2d 962 (Ala. 1987).
[50] *Restatement (Third) Trust (Prudent Investor Rule).*
[51] *Restatement (Third) Trusts (Prudent Investor Rule)*, p. IX.
[52] *Restatement (Third) Trusts (Prudent Investor Rule)*, § 379, p. 190; the committee also commented at § 389, pp 190-191, "absent contrary statute or other provision, prudent investor rule applies to investment of funds held for charitable corporations."
[53] Uniform Prudent Investor Act (1994), § 2(a).
[54] These concepts are summarized in the introductory remarks of the committee in the *Restatement (Third) Trusts* (Prudent Investor Rule) pp. 5-6.
[55] Schwinn, Elizabeth, "Falling Through the Cracks," *The Chronicle of Philanthropy* (November 14, 2002).
[56] Purdum, Todd S., "For $6 Billion Hawaii Legacy, a New Day," *The New York Times* (National Desk, May 15, 1999), <www.lava.net/cslater/$6Billion.htm>.
[57] *Michael T. Caracci and Cindy W. Caracci v. Commissioner of Internal Revenue*, 118 T.C. 25; also see Schwinn Elizabeth, "How '96 Law on Financial Abuses Has Been Applied by IRS in Four Cases," *The Chronicle of Philanthropy* (November 14, 2002).
[58] IRC § 6033(a). The Code requires that charities file with income of $5,000 or more; over time the IRS has increased this threshold to $25,000.
[59] IRC § 6104(d).
[60] A New York State Appeals Court allowed a donor lawsuit to enforce gift restrictions to proceed against St. Luke's –Roosevelt Hospital Center in 2002, stating: "The donor of a charitable gift is in a better position than the Attorney General to be vigilant and, if he or she is so inclined, to enforce his or her own intent." Greene, Stephen G., "Seeking Control in Court", *The Chronicle of Philanthropy* (November 28,

2002); Greene, Stephen G., "N.Y. Hospital Settles Case Filed by Donor's Widow," *The Chronicle of Philanthropy* (October 30, 2003).
[61] Wolverton, Brad, "What Went Wrong?", *The Chronicle of Philanthropy* (September 4, 2003).
[62] Payment of commissions for gifts is in violation of the Philanthropy Protection Act of 1995 (Public Law 104-62 (December 8, 1995)).
[63] Lipman, Harvy, "Unusual Arizona Group Shuts Down, Cutting Off Annuity Payments to Donors," *The Chronicle of Philanthropy* (November 1, 2001).
[64] "Federal Jury Indicts Ariz. Charity Head," *The Chronicle of Philanthropy* (March 6, 2003); *United States v. Robert R. Dillie* (U.S.D.C., District of Arizona), Criminal Action No. 03-CR-115-ALL, *Securities and Exchange Commission v. Robert R. Dillie and Mid-America Foundation, Inc., Defendants, and Mid-America Financial Group, In., Relief Defendant* (U.S.D.C., District of Arizona, Phoenix Division, Civil Action No. CV-01-2493-PHX-JAT).
[65] Lipman, Harvy, "Arizona Charity Executive is Accused of Fraud," *The Chronicle of Philanthropy* (January 10, 2002).
[66] Sterling, Terry Greene, *The Moneychangers*, Phoenix New Times, < www.phoenixnewtimes.com/issues/1998-04-16/feature.html/1/index.html>, (April 16, 1998). The loans were made to individuals in some cases, and to the subsidiaries in others.
[67] *Id.*
[68] Blum, Debra E., "$217-Million Deal Struck in Arthur Andersen Case," *The Chronicle of Philanthropy* (May 16, 2002).
[69] Carl J. Herzog Foundation vs. University of Bridgeport, 677 A.2nd 1378,
[70] Wolverton, Brad, "Bequest to Metropolitan Opera Challenged," *The Chronicle of Philanthropy* (August 7, 2003).
[71] Greene, Stephen G., "Seeking Control in Court", *The Chronicle of Philanthropy* (November 28, 2002); Greene, Stephen G., "N.Y. Hospital Settles Case Filed by Donor's Widow," *The Chronicle of Philanthropy* (October 30, 2003).
[72] See Daniel L. Kurtz, Protecting Your Volunteer: The Efficacy of Volunteer Protection Statutes and Other Liability Limiting Devices, available at WL at C726 ALI-ABA 263, 267 (Apr. 9 1992).
[73] Lipman, Harvey, "Multiple Sclerosis Association Settles Lawsuit Filed by N.J.", *The Chronicle of Philanthropy* (April 19, 2001).
[74] 42 U.S.C. § 14501.
[75] 42 U.S.C. § 14505(4), (6).
[76] 42 U.S.C. § 14505(6).
[77] 42 U.S.C. § 14503(a).
[78] Searches for cases related to state and federal volunteer liability laws reveal no interpretative law. While this means that litigation based on these laws is infrequent, it also means it is difficult to know how well these laws protect volunteers.
[79] The Model Act, § 8.51, *et. seq.*
[80] Most D & O policies do not cover excise taxes imposed by § 4941 or intermediate sanction assessments under § 4958 although the policies may cover legal costs to defend against such penalties.
[81] Specific questions include the limits of the D & O (or other) insurance coverage (including acts coverage and amounts covered), the retention level on the insured's, and the amount of co-insurance, if any (per claim and aggregate).
[82] Rev. Rul. 82-223.
[83] 56 Federal Register 48465.
[84] TD 8639.
[85] Sample policies are available at the author's website at <www.giftplanners.com.>
[86] <www.boardsource.org>.
[87] Charities that have state law income thresholds for audits, receive government grants, receive threshold amounts from the Combined Federal Campaign, or receive private foundation grants with audit requirements may find that an annual audit is required. For those that are not required to have an audit, it may be advisable to implement that practice.