

Financial Planning

THE VIEW FROM LOWRY HILL

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THIS ISSUE'S FEATURED TOPIC:

In 2007, charitable giving surpassed the \$300 billion mark (*Giving USA 2008*). As nonprofits grow in size and magnitude, it's more important than ever for board members to understand both their evolving role and the significance of their contributions to accomplishing an organization's mission. While serving on a nonprofit board clearly has its rewards, greater IRS and congressional scrutiny—along with the volatility of today's financial markets—further reinforces the need for board members to know their fiduciary responsibilities, assess their risk of personal liability and to be continually educated.

This issue of *Financial Planning: The View from Lowry Hill* will:

- ◆ *Define the fiduciary responsibilities of a director.*
- ◆ *Identify protections one should consider before accepting a board position.*
- ◆ *Provide practical suggestions for making board service successful.*

WHAT IT MEANS TO SERVE ON A NONPROFIT BOARD

Have you been approached about serving on a nonprofit board? Are you already on a board? In either case, you've probably evaluated the position within the general context of "making a difference." While this decision will undoubtedly impact you with respect to time, money, and perhaps personal and professional reputation, there are also specific responsibilities to acknowledge as a board member. A nonprofit's board of directors is its governing body. As such, it has the principal responsibility for fulfilling the organization's mission and being legally accountable for its operations. Whether the governing document refers to them as directors or trustees, the board is serving in a fiduciary capacity through managing the assets of the entity for the public good. While the specifics may vary from state to state, directors have three primary fiduciary responsibilities: the duties of care, loyalty and obedience to the law.

DUTY OF CARE

The duty of care requires a board member to exercise reasonable care when making decisions for the organization. Prior to making a business decision, board members are required to become informed of all relevant and material information reasonably available to them. For example, familiarity with the organization's mission, policies, operations, budgets, financial statements and investment management processes is essential. Moreover, participation in meetings and committees is a must. A director will usually avoid legal liability as long as the decisions made were informed, in good faith and without a conflict of interest.

DUTY OF LOYALTY

The duty of loyalty focuses on acting in the best interests of the organization and placing those interests above the director's own personal interests. For example, a director should not vote on any matter that would benefit him or her at the expense of the organization. Even though the member abstains from the vote, he or she should disclose any potential conflicts or personal benefit that may result from such a vote. It would also be prudent for the director to defer participation in any discussion of the matter. Every board member should be aware of the other members' community and business associations. Conflicts of interest are only avoided through full and honest disclosure.

DUTY OF OBEDIENCE

The duty of obedience requires the director to act in accordance with the organization's mission and purpose. For example, the director should make sure he or she modifies activities in order to comply with law changes, oversee employees or agents, and stay consistent with the organization's purpose within the law and the entity's governing documents. Directors who breach this duty may cause the organization to lose its tax exempt status.

MANAGING RISK

Triggered by public accounts of financial scandals and misdoings, and in the wake of the Sarbanes Oxley Act of 2002, the nonprofit world is scrutinized more closely today than in the past. Along with the general legislative changes that Congress has enacted, the IRS now engages in greater compliance and regulatory enforcement. This trend is expected to continue. Increased oversight makes it crucial for nonprofits and their advisors to stay current with respect to new developments, and to implement policies and procedures in order to comply with these changes.

What might happen if a board member's duty is breached? Could a board member be held personally liable? If so, is there a way of minimizing this risk? Both the nonprofit organization and its governing body need to be aware of and protected against areas of potential liability. The primary landmines for liability include investment management, employee management, third-party liability, compliance with federal and state laws, and fund accountability. Board members must be familiar with the organization's budget, balance sheet and audited financial statements. The board is also responsible for filing tax returns, ensuring that adequate accounting systems and controls are in place, and complying with various state and/or federal regulations. Finally, the board members are the legal trustees for investing and managing the assets of the nonprofit. Even if these duties are assigned to third parties, the board must oversee those agents. For example, if the board hires an investment manager, the board is still required to review, supervise and document the investment activity.

While many states have laws limiting liability, directors can and have been personally sued for decisions or failure to make decisions while serving on nonprofit, religious and civic boards. Simply defending oneself in such a situation may be the most expensive aspect of a suit, regardless of whether any liability is ultimately assessed. To manage such risk, many nonprofit organizations purchase Directors and Officers ("D&O") Insurance.

DIRECTOR & OFFICER LIABILITY INSURANCE

When contemplating whether to accept a board position, a person should ask whether the organization has such insurance and if so, review the coverage provisions. Some items to look for in these policies include:

- ◆ *Coverage for directors, officers, employees, volunteers and committee members (including past members)*
- ◆ *Marital estate extensions that cover spouses that may be enjoined in a suit or an estate after death*
- ◆ *Employment practices liability that provides coverage for discrimination, sexual harassment, wrongful termination and other employment related issues*
- ◆ *Defense costs*
- ◆ *Entity coverage to protect the organization in addition to specified individuals within the organization*

D&O insurance is most commonly held by larger nonprofit organizations; smaller organizations may not have such coverage. In those situations, other methods of protection may be available, such as exculpatory language, indemnification provisions and additional umbrella insurance coverage.

INDEMNIFICATION PROVISIONS

The organization's governing documents should be carefully reviewed. The articles of incorporation or bylaws will often contain specific exculpatory provisions limiting a director's liability or indemnification language if a director is found liable. Many states' laws also allow organizations to limit the personal liability of their directors. However, these provisions typically will *not* provide protection for acts or omissions made in bad faith or for intentional misconduct.

PERSONAL UMBRELLA COVERAGE

Another option for protection is to purchase umbrella liability coverage from the director's own personal insurance carrier. If this alternative is selected, the policy should be carefully reviewed to ensure that it covers religious, charitable, civic and nonprofit board service.

Notwithstanding the more formal protections previously cited, there are some simple, practical guidelines to follow when accepting a board position. Prior to making such a commitment, the potential director should, at a minimum:

- ◆ *Research the organization on the GuideStar database (where information on the entity's mission, goals, accomplishments and financials is available).*
- ◆ *Solicit the organization's audited financial statements, the articles of incorporation, bylaws, and any other organizational and legal documents.*
- ◆ *Review the prior year's Form 990 (i.e., the required annual IRS filing for nonprofits).*
- ◆ *Ask specific questions about the board: How often does it meet? What is the time commitment required of board members? What expertise is expected to be brought by the potential board member? Is there a financial commitment, and are board members expected to raise funds? How are new directors chosen, and who currently makes up the board? How long do directors serve? What are the board's current committees? Is there specific training or orientation provided to new board members?*

ONLINE RESOURCES TO FURTHER ASSIST YOU IN LEARNING ABOUT AND EVALUATING BOARD MEMBERSHIP

- ◆ www.boardsource.org
- ◆ www.compasspoint.org/boardcafe/index.php
- ◆ www.managementhelp.org/boards/boards.htm
- ◆ www.boardnetusa.org

After completing the due diligence and making the decision to join a board, the following considerations should also be kept in mind when embarking on this endeavor:

PRACTICAL SUGGESTIONS FOR A SUCCESSFUL BOARD EXPERIENCE

- ◆ Attend meetings.
- ◆ Read the minutes, and make sure they are correct.
- ◆ Review financial statements, and make sure you *understand* them.
- ◆ Be proactive and vocal—voice objections, and promote debate on controversial or difficult issues.
- ◆ Be familiar with the organization’s policies and procedures; make sure they are up-to-date, authorized by the board and understood by management.
- ◆ Ensure that all employment and income taxes are paid.
- ◆ Seek the advice of experts where appropriate. Having done so, make sure all third parties are accountable for their tasks (e.g., investment managers, accountants, attorneys, etc.).

A nonprofit board can have a tremendous impact within the community. Serving on a board can also be very rewarding, educational and energizing. However, no board member ever wants to hear “Where was the board when this happened?” Undoubtedly, that question may lead to a director’s worst nightmare! By understanding the responsibilities and potential liability associated with serving, you will become a more informed and *more effective* board member.

The aforementioned content is provided only as general information and should not be relied on as definitive facts about changes to current tax laws. Opinions and recommendations contained herein should not be construed as investment advice.

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