FOLEY HOAG LLP

Driving Business Advantage

THE DIRECTORS' DOZEN

Prudent Activities for Governing Boards of Nonprofit Corporations

Directors of nonprofit corporations owe fiduciary obligations to the corporation. They are bound by Massachusetts law to perform their duties as directors in **good faith**, in a manner reasonably believed to be in the **best interests of the corporation**, and with such care as an **ordinarily prudent person in a similar position** would exercise under similar circumstances. As stewards of the nonprofit corporation, directors are required (1) to act with care in their oversight and, (2) to keep the interests of the corporation paramount above their own personal interests when acting for, or on behalf of the corporation. These legal duties are known as the **duty of care** and the **duty of loyalty.**

The following guidelines describe some actions directors should take to fulfill their legal duties.

1 Be Engaged

An engaged board is a prudent board. Board members should be informed about the nonprofit corporation's programs, finances, and operations. In order to exercise proper oversight of the organization's affairs, each board member must ask questions, review information, and attend board meetings. It is a good practice for the board to meet in "executive session" for a portion of each board meeting without management or staff present as this tends to encourage frank discussions among board members.

The board does not have to meet each month, but it should hold regular meetings. This is the best way for board members to keep informed of the activities of the corporation and for the board to provide the appropriate guidance to management.

A board of directors may reasonably delegate certain actions to other persons, and indeed, many boards rely on the work of committees and others. However, the board of directors must always retain oversight and supervision. **The board may delegate responsibly, but may not abdicate responsibility.** When delegating authority to others and when relying on information prepared by others, the board must have a good faith belief that these persons merit the board's confidence and that they are competent and reliable. Because of the significant delegation and reliance placed on the chief executive, hiring, supervising, and evaluating the chief executive are among the most important functions of a board.

2 Implement the Mission

The board should confirm that the organization is pursuing the mission described in its governing documents and its application for exemption from federal income tax (if any). It is useful to re-read these documents from time to time. **The organization's mission must benefit the public. The organization may not promote private interests or a commercial mission.** The consequences of violations — financial penalties and revocation of tax-exempt status — are severe.

The board should consider other factors in light of its mission: do changes in the law or the organization's industry have any impact on the organization's ability to continue its mission as a nonprofit corporation? Is the organization using its funds to accomplish its mission? Are donor restrictions being observed? If the organization is a private foundation, does it abide by the minimum distribution and other rules applicable to private foundations?

3 Put the Nonprofit Corporation First; Address Conflicts of Interest

A director's duty of loyalty to the corporation requires that the corporation's interests come first; a director's personal and business interests are subordinate to the corporation's interests. This means for example, that if a director becomes aware of an opportunity that would be of interest to the corporation but is also of personal interest to the director, the director must ensure that the corporation has the first chance to pursue the opportunity. **This also means that a director should keep secret the organization's confidential information.**

Conflicts of interest – whether actual, apparent, or perceived – are not inherently bad or prohibited. However, they must be disclosed and reviewed, and any transaction that may present a conflict of interest should be approved in advance by disinterested directors. **A prudent board will adopt a written conflict of interest policy and follow its procedures for any transaction that may present a conflict of interest.** Federal tax law imposes severe financial penalties (on the organization and on directors and officers who approved the transaction) for transactions (including employment compensation) that confer an "excess benefit" to executives and other insiders. There are simple steps that may be followed in advance of a transaction in order to obtain a (rebuttable) presumption that the transaction is reasonable for federal tax law purposes. Sometimes, even if a transaction may be fair and reasonable to the corporation and in its best interests, entering into a transaction with an insider may cause too much negative attention to be worth pursuing. Note that there are special rules about self-dealing that apply to private foundations.

4 Approve and Manage the Budget

The board must take responsibility to adopt a written budget that reasonably projects sufficient revenues to cover the anticipated expenses of the nonprofit corporation in each year – whether the revenues come from grants or gifts, or the provision of goods and services. The board should receive regular updates throughout the year on the organization's progress against its budget.

The board should also review and consider material obligations of the organization, such as loans and office leases.

5 Approve Compensation

The board must consider and approve executive compensation. The board should consider executive compensation in light of many factors, including the executive's performance, the organization's success in meeting its mission, comparable compensation by similar organizations, the compensation framework for the entire organization, and the organization's financial resources.

In addition, a prudent board approves a budget that establishes a framework in which the executive director and other managers may fix the salaries of the corporation's employees.

6 Oversee the Investment Assets

The board must review the investment management of the organization's assets and adopt an investment policy and a spending rule. The board should be familiar with state law setting forth guidelines for the investment and use of a nonprofit corporation's assets.

7 Review the Financial Statements and Meet with the Auditors; Review IRS Form 990

The organization's financial statements should be reviewed by the board before being approved and filed. Some members of the board and the audit committee should have relevant financial expertise. The board or the audit committee should talk with the auditor without any staff present. The auditor works for the board, not for the chief executive officer. The board or the audit committee should set aside time to meet with the auditor without staff present to learn about any matters of concern to the auditor that should not be communicated through the staff.

It is good practice for all members of the board to be familiar with IRS Form 990 before it is filed. Form 990 (and in some cases, the organization's financial statements) is a public document that contains a significant amount of important and detailed information about the organization.

8 Cause the Corporation to Make Government Filings and Pay Any Government Fees and Taxes Due

Many federal, state, and local governmental agencies will impose penalties on a corporation if required filings are not made on a timely basis. A prudent board will ensure that such penalties are avoided. The most important filings for a nonprofit corporation include the following: annual filings with the Secretary of State and Attorney General in the state in which the organization is located; employee income tax withholdings with the Internal Revenue Service and the state department of revenue; and Form 990 (or related filings) with the Internal Revenue Service.

Note that in Massachusetts and many other states, failure to pay employment taxes causes interest and penalties to accrue, and the officers and directors may be held personally liable for the full amount of any such unpaid taxes. There is also personal liability for failure to pay employee salaries and accrued vacation.

Note that in some states such as Massachusetts, nonprofit corporations do not automatically have an exemption from the payment of property taxes, and applications for abatement must be filed within the applicable time periods. Nonprofit corporations typically must also file for exemptions from sales and personal property taxes.

9 Keep Good Minutes

Minutes of board meetings and key committee meetings are important. **Minutes are a record of the care and diligence that the board or committee exercised in arriving at its decisions and in overseeing the corporation's programs, operations, and finances.** Minutes should not be a stenographic record of the proceedings, but they should address the key factors that influenced major board decisions. They should explain the reasoning behind decisions that are especially prone to being second-guessed. Key board committees should provide regular updates to the board.

10 Comply with Fundraising Rules

The board should ensure that the organization is registered as necessary in each state in which it is raising funds. The board should also be sure that the organization has considered the implications of its use of the Internet to raise funds. Some states, such as Massachusetts, also regulate lotteries, raffles, bingo, and other gaming activities commonly used for fundraising.

11 Adopt and Implement Operational Policies

IRS Form 990 asks whether the organization has several policies, such as a document retention policy, a joint venture policy, and a whistleblower policy. Some written policies may be required. **The board should consider whether the organization needs such policies and be sure that the policies are followed.** The organization must have signing authorities in place so that it is clear who may transfer funds and make binding commitments on behalf of the organization.

12 Monitor Political Activities and Lobbying

All section 501(c)(3) tax-exempt organizations are prohibited from engaging in political campaigns. The resources of such organizations, including e-mail addresses and employee time, may not be used for such activities. **In addition, certain nonprofit organizations may engage in only a limited amount of lobbying activity.** Board members should be familiar with these rules in order to determine whether and to what extent these restrictions apply. The consequences of violation – financial penalties and revocation of tax-exempt status – are severe.

Foley Hoag is a 225-attorney firm with offices in Boston and Waltham, MA and Washington DC. Through these offices, we help clients in diverse industries such as technology, energy, life sciences, healthcare and professional services gain a competitive advantage by providing strategic legal advice tailored for their business goals at every stage of their growth. In addition, we represent many nonprofit and tax-exempt organizations across all industries. Our office in Washington DC also serves as our bridge to the international marketplace with highly respected practices in both international arbitration and litigation and corporate social responsibility. Our practice mix reflects a powerful blend of regional, national and international expertise. We are focused on what we do best - helping our clients succeed with their business goals. For more information, visit www.foleyhoag.com.

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