Association of Christian Schools International

Board Governance

Responsibilities and Duties of a Director of a Nonprofit Organization

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With many nonprofit organizations, there has been a tendency to select members of the board of directors on the basis of the prestige these directors will lend to the organization. Many directors respond by regarding the position as an “honorary” or “figurehead” type of position, rather than actively participating in the direction and oversight of the organization.

Also, a number of nonprofits have boards that are self-perpetuating, and thereby seem to become a law unto themselves. Directors serving on this type of board may fall into the trap of thinking that they can do whatever they desire with the corporation even if the activities are not in the best interests of the organization. This is often true when the founder retains power and considers the organization his or her own.

Neither view is correct. Directors must actively oversee the operation of the organization. By law, they are subject to certain fiduciary obligations. Depending on state law, the standard of care applied may be the “prudent person” standard applicable to the trustee of a trust.

This analysis examines the questions that should be asked by directors in determining the scope of their responsibilities and how these responsibilities should be fulfilled. Although other questions may be relevant in specific situations, directors who follow the approach outlined below should be well on the way to fulfilling their legal commitments to the organization. The following questions should be asked:

1. What are the stated purposes of the organization?

2. Does the transaction advance the stated purposes?

3. Does the transaction benefit a private individual?

4. Were any promises made when the funds were raised?

5. Where any conditions placed on the donated funds?

6. Does the director attend the meetings?

7. Are meetings held regularly?

8. Does the director have all the relevant facts?

9. Is there any reason not to trust the information being furnished?

10. Are taxes being paid?

11. Is there a conflict of interest or self-dealing?

12. Is the transaction fair to the organization?

13. How would an ordinarily reasonable and prudent person decide the matter?

14. Are there other laws that affect the particular situation?

15. How accurate are the records?

16. Is the director acting honestly, in good faith, and with total integrity?

17. Is this transaction in the best interests of the organization?

What are the stated purposes of the organization?

A nonprofit organization must use all of its assets to advance the purposes for which the organization was formed, as set out in its articles of incorporation and/or bylaws (stated purposes). These stated purposes are controlling over all other statements of policy issued by the organization.

Assets may be used for both direct and indirect expenses. If feeding the poor is a stated purpose, the cost of the food and its distribution are direct expenses, and the cost of administration for the program and solicitation of funds are indirect expenses. All of these costs are justified. However, expenses to fulfill another purpose not included in the stated purposes of the organization are not justified, even if this other purpose is more commendable.

Directors should, on taking office, review the organizational documents (articles, bylaws, and constitution) to become fully aware of the stated purposes. All decisions of the board should be made, and all corporate policies developed, in light of those stated purposes.

Does the transaction advance the stated purpose?

Directors should review each major transaction to test whether it advances, either directly or indirectly, the stated purposes. If there is any doubt, the board should postpone the transaction until there is a consensus as to how the transaction advances the corporate purposes. The minutes of the board meeting at which the matter is considered should reflect this rationale.

Does the transaction benefit a private individual?

Nonprofit organizations having a public or charitable benefit, including religious organizations, are normally exempt from taxation under IRC Section 501(c)(3). This section prohibits organization assets from being used primarily to benefit an individual. An organization can pay employees adequate salaries and benefits without violating this provision. And an activity that benefits the organization is permitted even if an individual receives a benefit. However, the board should determine what the benefit is to the organization before an activity may be implemented, and the minutes should reflect the benefits of the activity. If the board determines that the primary benefit is to an individual, then the activity should not be implemented.

If this requirement is violated and private benefit is found, the organization's tax-exempt status may be lost. In fact, a finding of private inurement has been the basis for denying tax-exempt status to "mail-order" churches.

In reviewing any transaction, a director must make sure that the activity does not result in "private benefit."

Were any promises made when the funds were raised?

Funds raised for a specific purpose must be used for that specific purpose and no other. Generally, the organization should either return the funds to the donor, or obtain a waiver of the original purpose from the donor, or a court order directing disposition before the funds are used for another purpose. State law may affect the steps necessary to change the use of the funds.

An organization should generally qualify even special appeals to allow funds raised to be used at the discretion of the board. If representations are made when the funds are raised, the director must see that those funds are used in the manner represented.

Were any conditions placed on the donated funds?

Assets may be given to an organization conditioned on those assets being used for a specific purpose. The organization may either accept the assets for that purpose, if it is consistent with the organization's stated purposes, or refuse to accept the assets subject to the condition. The organization may not accept the assets and use them for a purpose other than the purpose stated by the donor.

Does the director attend the meetings?

One duty of a director is the duty of reasonable care.

Regular attendance at meetings of the board and board committees is an obvious requirement for acceptable director performance.[1]

To fulfill their responsibilities, directors must provide direction for the operations of the organization. State laws generally allow for proxies for members but not for directors. If directors are unable to regularly attend the meetings of the board, they will be unable to provide the necessary guidance to the organization. Further, the directors will remain responsible for actions taken by the board, even in their absence.

Before agreeing to become a director, individuals should consider the necessary time commitment. If they are unable to make the commitment, the position should be declined. A director who later becomes unable to attend board meetings regularly would be well advised to resign.

Are meetings held regularly?

To make an informed decision about an action, a director must have all the relevant facts. For instance, if the organization proposes to construct a new building, the board should review any zoning issues, building permits, costs of construction (with bids), proposed financing arrangements, and similar factors before approving or disapproving the plan. The board also should review any legal consequences of its decision and examine any alternatives (such as buying an existing building) that would be more beneficial to the organization.

A director should insist on having all of the appropriate information to review and should review the information before making a decision.

If for any reason sufficient information is not made appropriately available, the corporate director should request that action be delayed until the information is made available. If action is nonetheless taken, the corporate director should at a minimum request that his abstention, and reason therefor, be recorded in the minutes of the meeting. Under these circumstances, he should consider the need for his resignation…[2]

Is there any reason not to trust the information being furnished?

Directors are responsible for the overall activities of the organization, but generally do not manage the organization on a day-to-day basis. Consequently, they normally do not directly gather the information about the proposed activities. Unless there is some reason to suspect the reliability or competence of the individual furnishing the information, the directors may rely on the information furnished. However, directors must make whatever additional inquiries are necessary to satisfy themselves as to the validity of the information furnished if there is reasonable doubt of its reliability.

Are taxes being paid?

If the organization has employees, income taxes and, in most cases, social security taxes must be withheld and paid. If they are not withheld, the organization may still be liable for the amount that should have been withheld. The organization, any responsible individuals, and often the directors themselves will be found to be personably liable for the amounts due even when the directors did not know these payments were not being made. This is especially true if the director had signatory authority on the bank accounts.

Is there a conflict of interest or self-dealing?

Each director has a duty of complete loyalty. Directors may not use the position of director for personal profit or to gain a personal advantage. A director cannot personally take advantage of an opportunity that belongs to the organization; nor can directors use the organization to better themselves. For instance, if the organization is looking for a piece of land and the director finds a suitable parcel for a good price, the director cannot buy the parcel and then sell it to the organization for a higher price. If the director already owns a suitable parcel of land, he or she cannot sell it to the organization for more than its value to the organization. And, if the director owns a parcel of land that is unsuitable, he or she should not attempt to sell it to the organization.

It is preferable to entirely avoid any activity that involves self-dealing (that is, any activity between the person as an individual and the person as a director/trustee). If self-dealing is unavoidable or is clearly of benefit to the organization, most states will allow it. However, the director should make sure that the conflict of interest is disclosed, that it does not result in an unjustified advantage to the interested director, and that it is beneficial to the organization. Even if this is done, some states will allow the transaction to be voided at the option of the organization, regardless of the results.

Corporate loans to either directors or officers are one type of self-dealing that is of particular concern. Directors who vote in favor of these loans may be liable for them in the event that the loan is unauthorized or otherwise impermissible. Boards must check the state law under which they are incorporated before considering these loans.

The director should make sure that state law permits the self-dealing transaction. If it does, the director should make sure that the conflict of interest is totally disclosed and that the activity is beneficial to the organization itself.

Is the transaction fair to the organization?

A director should determine whether an activity is fair and reasonable as far as the organization is concerned. This is normally a judgment call; however, if self-dealing is involved (see above), then the transaction must actually be fair and reasonable.

How would an ordinarily reasonable and prudent person decide the matter?

Corporate directors are expected to choose the course of action that an ordinarily reasonable and prudent person would choose in the same or similar circumstance. However, with a nonprofit corporation, that standard may differ from the standard applied in a business setting when viewed in the light of the purposes and ideals of the organization.

Therefore, the decision should not be made on the basis of what an ordinarily reasonable and prudent person in a business setting would decide, but what an ordinarily reasonable and prudent person would decide in light of these purposes and ideals. With a religious organization, the religious beliefs and doctrine must also be taken into account.

Are there other laws that affect the particular situation?

There are laws that might affect both the liability of the corporation and the directors' liability of the corporation and the directors' liability in a particular area. For instance, the organization and its directors are not exempt from the securities laws, or from criminal laws regarding fraudulent activities. And some nonprofits have found that the antitrust laws apply to them. This type of information should be part of the information provided when a particular activity is considered by the board.

How accurate are the records?

Another duty of a director is the duty to account. To do this, the records of an organization must be accurate. There should be sufficient internal accounting and management procedures to assure the accuracy and control of the organization's activities and funds. As part of the record keeping, there should be no commingling of funds among directors' assets, the organization's assets, and the assets belonging to any other individual or organization. Assets should be held in the name of the organization or in the name of an individual in trust of the organization or for a specified purpose.

The records and accounting of the trustees should constitute a complete and a clear, accurate and distinct report and disclosure in detail of the administration of the trust, showing receipts and their sources, payments by [the trustee] and the balance remaining to the end of distributing to the beneficiary trust property or funds or their value, with income thereon and increments thereto, and without profits to the trustee, although allowing [the trustee] compensation and reimbursement.[3]

The duty to keep records extends to the corporate records as well as the financial records:

A corporation shall keep as permanent records minutes of all meetings of its members and board of directors, a record of all actions taken by the members or directors without a meeting, and a record of all actions taken by committees of the board of directors…shall maintain appropriate accounting records…shall maintain a record of its members in a form that permits preparation of a list of the name and address of all members…shall maintain its records in written form or in another form capable of conversion into written form within reasonable time.[4]

Members generally have the right to review any of these records.

Is the director acting honestly, in good faith,and with total integrity?

The duty to act in good faith requires directors to perform their duties honestly and with integrity. This duty incorporates a number of duties already discussed. For instance, directors cannot rely on information they know to be false or engage in self-dealing without violating this duty.

Is this transaction in the best interests of the organization?

Once a director has reviewed all the issues relevant to the transaction, found the transaction to be consistent with the purposes of the organization, and reviewed all the information concerning the matter, then the director should take the opportunity to look at the entire picture. At this time, the director should make a determination that this activity or transaction is in the best interest of the organization and that there is no better alternative available at the present time.

If directors ask all the questions listed above and act in accordance with the suggestions, it is likely that the directors will be performing their duties satisfactory. However, things can still go wrong, even with the most well-intentioned director and organization. The second step is to document the fact that the decisions of the directors were made after due consideration of the various factors. The greatest liability and exposure occurs, not when a wrong decision was made after due consideration, but when no decision was made at all or was made without due consideration. If proper documentation is made beforehand (for example, in the minutes of the board meetings), a court is unlikely to second-guess the decision of the board.

One basic practical difference between a profit and a nonprofit corporation in the area of directors' liability boils down to this: if the board of a for-profit corporation is sued and wins on the question of liability, the primary cost is the cost of defense. If the board of a nonprofit corporation is sued, even if it wins on the question of liability, it loses the cost of defense and, more importantly, it may lose credibility with its donors. This loss of credibility may be difficult or impossible to repair. A recognition of this danger and a strategic plan to avoid the neutralization of the charity by careful attention to the above issues will limit the risk that a legal test would ever be contemplated.

References:

1 "Corporate Directors Guidebook," The Business Lawyer, Volume 33, No. 3 (April 1978).
2 "Corporate Directors Guidebook," The Business Lawyer, Volume 33, No. 3 (April 1978).
3 76 Am. Jur. 2d, Section 507.
4 "Revised Model Nonprofit Corporation Act," p.382. Prentice Hall Law and Business.