

# THE MANAGEMENT FILE

## DIRECTORS' AND OFFICERS' LIABILITY FOR NONPROFIT ORGANIZATIONS

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Many 501(c)(3) nonprofit organizations have inspiring stories behind their creation. It's not uncommon for passionate founders and directors to devote years of hard work and their own funds to move the conception of an idea into the birth of an organization dedicated to their cause. Often with little or no monetary compensation, nonprofit directors and officers rely on intangible rewards—the stories of the difference they've made in the community and peoples' lives—as incentive to continue laboring over their mission.

*But a costly lawsuit could quickly put an end to that story.* Do people really sue nonprofit organizations? The answer is yes. As society becomes more litigious, nonprofits are increasingly vulnerable to lawsuits that threaten their operations and, in some instances, drain their limited funds to the point where they have to close their doors. At the point where a nonprofit reaches insolvency, directors' and officers' personal assets are at risk.

Although armed with perpetual energy for their cause, nonprofit officers and directors are sometimes ill-equipped with the business acumen or financial resources to manage the liabilities of their nonprofit in the same way as a for-profit corporation. Some simply don't understand or are not cognizant of their legal liabilities. This article outlines the risks that nonprofit directors and officers can encounter, including information about the legislation that affects nonprofits, the types of claims brought against directors and officers, and ways to mitigate the risk of a costly claim.

### The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act (SOX) Act of 2002 was created in response to the major corporate scandals of publicly traded companies such as Enron and Tyco in the early 2000s. Enacted to protect investors in those companies, SOX aims to increase the truthfulness in corporate disclosures.

While the majority of the SOX provisions appertain to publicly traded companies, *nonprofits are required to comply with two provisions: Whistleblower Protection and Document Destruction.* Under the Whistleblower Protection provision, nonprofit directors and officers must not retaliate against those who report suspected illegal activities in the organization. This means that your employees and volunteers can express concerns about unethical and unlawful practices that happen in your organization without fear of reprisal from you or other members of the management team. Under the Document Destruction provision, nonprofit directors, officers and employees cannot destroy documents that are intended for use in official proceedings. This means your organization must retain certain documents, such as financial records and board meeting minutes, for a specific period of time. Each state has specific regulations for how long documents must be kept.

Some states require nonprofits to adhere to more than the two required SOX provisions; and some nonprofits have voluntarily adopted all of the provisions as a best practice to bolster their credibility and promote financial transparency in their organization.

### Areas of Nonprofit Directors and Officers (D & O) Liability

In addition to the two SOX provisions, there are a variety of other liabilities that can affect nonprofit directors and officers. According to a 2012 survey conducted by Towers Watson, a global professional services company, 63% of the surveyed nonprofit organizations reported claims in the last 10 years, which were more claims than the public and private companies reported.

*Some major areas of exposure for nonprofit directors and officers include: employment practices, fiduciary duty breaches, conflict of interest, government enforcement actions and misuse of funds.*

#### *Employment Practices*

For nonprofits that hire paid employees, employment practices liability is a significant risk. The same employment laws that apply to for-profit corporations are also applicable to nonprofits.

With a limited budget, most nonprofits don't have a human resources department or the knowledge of employment practices that a for-profit corporation may have. Either directors and officers don't realize they're liable, or they have poorly defined employment policies and procedures in place.

To mitigate the risk of an employment practices claim, invest the time in developing a hiring policy and an employee handbook. Criminal background checks, education checks and past employer references can uncover information about a potential troublesome employee. For all paid staff members and even volunteers, provide an employee handbook so they are aware of their job duties, vacation time, benefits and other organizational policies. Maintain accurate personnel files on all employees and record all incidents in which you had to reprimand, discipline or terminate employees, as these records are necessary in the event of a lawsuit.

### ***Fiduciary Duty Breaches***

Similar to for-profit corporations, nonprofit directors and officers are also responsible for fiduciary duties owed to the nonprofit, to the other directors and officers, and to third parties such as donors and members. Directors and officers can be liable for grossly neglectful decisions and wasting resources. This is known as the "duty of care." The three fiduciary responsibilities include:

1. *Duty of care.* Directors and officers must exercise reasonable care, actively participate in decision-making and are held liable for ordinary negligence. Ignorance is not an excuse.

2. *Duty of loyalty.* An officer or director must not use his or her position to pursue outside transactions or interests.
3. *Duty of obedience.* Directors and officers must comply with all federal and state reporting requirements, and ensure the nonprofit is dedicated to its stated mission statement and goals.

Fiduciary duties for nonprofit directors and officers are similar to the fiduciary duties for-profit corporation directors and officers owe their shareholders. Lawsuits for a breach of fiduciary duty can be brought by fellow officers and directors, the state attorney general, the nonprofit's members or the IRS. In some fiduciary breach cases, the IRS could revoke a nonprofit's 501(c)(3) tax-exempt status.

### ***Conflict of Interest***

A breach of the fiduciary duty of loyalty is usually manifested in the form of a conflict of interest. This occurs when directors and officers use their power for their own interest, or that of another interest or entity. Conflicts of interest include self-dealing or benefit activities in which officers, board members or staff have personal financial gain from the nonprofit.

It is crucial for a nonprofit to self-monitor potential conflicts of interest that exist among board members and directors. For example, you may have a board member who serves on the board of two different nonprofits competing for the same grant funding. Develop a conflict of interest policy and ask directors and officers to disclose all conflicts of interest on an annual basis.

### ***Government Enforcement Actions***

Nonprofits must follow applicable laws, including tax, civil rights and employment laws. All nonprofits must file an annual tax return with the IRS. Nonprofits with annual gross receipts of less than \$50,000 must file the Form

990-N (e-Postcard) and those with annual gross receipts over \$50,000 must file the Form 990. Directors and officers must ensure these forms are filled out correctly and are submitted by the deadline. A nonprofit's 501(c)(3) tax-exempt status could be in jeopardy if you fail to file or file the form past the deadline without asking for an extension.

Excessive employee compensation is closely monitored by the IRS and could result in costly fines. Employee compensation must be reasonable and comparable to other nonprofits of a similar size. On the new IRS Form 990, a nonprofit must report if any employees are compensated more than \$100,000 annually.

Additionally, the state attorney general's office usually monitors nonprofits to ensure they are following their stated mission and goals and applicable state laws. Conducting activities outside of your mission could expose you to scrutiny. Some of these activities simply might require you to pay a tax, such as if the activity generates revenue, but penalties and loss of tax-exempt status could result if the activities are unrelated to the mission.

### ***Misuse of Funds***

A nonprofit relies on grant funding and donations to operate, but it is important that funds are used for the stated mission and goals. Directors and officers are liable for how funds are used. Even if you were not present at a meeting where a financial decision was made, you can still be liable for the misuse of funding.

Misappropriation of funds can also be tied to claims made by donors that a nonprofit did not use their donation for an intended purpose. Some donors sue nonprofits that misrepresent their financial status. If a donor designates funding for a particular project or program, they can enforce the terms of the gift. Although these claims are not as common, you should still be wary of the liability.

To mitigate this risk, directors and officers should always aim to present a transparent financial picture of their organization to avoid lawsuits from donors. Accurate bookkeeping and filing the IRS Form 990 in a timely manner is essential. Be aware of volunteers or employees who handle money as there could be a risk of swindling funds.

### **Immunity and Indemnification**

Given all of the potential claims that can be made against nonprofit directors and officers, there is some protection against potential lawsuits.

#### *Statutory Immunity*

The Revised Model Nonprofit Corporation Act of 1987 states that directors must actively participate in decision-making and act carefully in fulfilling their responsibilities. If decisions are made or actions are done in "good faith," directors and officers can claim immunity in potential lawsuits. Even if it was considered a bad decision, you will not be held liable if you can attest that the decision was made in good faith.

However, while immunity protects directors and officers from guilt, you can still incur court costs proving that you are immune.

Some important things to note about immunity:

- If a director or officer is paid, he or she is not immune.
- If a director or officer acted with gross negligence, he or she is not immune. Simply put, gross negligence is carelessness or reckless disregard, causing harm to the safety, lives or property of others.
- Immunity from liability does not mean directors and officers are immune from being sued and incurring the court costs of proving your immunity.

### *Indemnification*

Directors and officers can also be protected with indemnification, which is when the nonprofit uses its own resources to pay for legal costs for claims that result from board service. This protects directors and officers from using their personal assets to pay for legal costs. Some nonprofits have an indemnification policy written into their bylaws. However, keep in mind that if the nonprofit's financial assets deplete, the personal assets of directors and officers are at risk.

### **Transferring Risk with D & O Insurance**

Since indemnification and statutory immunity have its limitations, some risk may have to be transferred by purchasing a Directors and Officers (D & O) insurance policy. Depending on the size and budget of the nonprofit, it's typically not a large expense, but can save the nonprofit in the event of an expensive claim.

Also, D & O insurance can offer protection for board members who would otherwise have to use their own personal assets to prove immunity or pay for defense costs. Potential board members are often reluctant to join a board if a nonprofit does not have D & O insurance.

While General Liability insurance policies cover bodily harm and property damage, they do **not** cover the risks highlighted in this article. In some cases, if you purchase D & O insurance, Employment Practices Liability insurance and Fiduciary Liability insurance must be purchased separately as well for adequate protection.