K&L GATES

HANDBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS IN THE UNITED STATES

A Primer on Directors' Duties and Rights and Minimizing Risk

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PURPOSES AND GOVERNANCE

The purposes of nonprofit corporations vary greatly. Many nonprofit corporations are charitable in nature; others serve educational, religious or similar purposes. Still others, such as trade associations and social organizations, are more fraternal in nature. Many states allow nonprofit corporations to be formed for any lawful purpose. As a result, not all nonprofit corporations qualify for exemption from federal income taxation. Nonprofit organizations may also be organized as trusts, rather than corporations.[1]

U.S. nonprofit organizations can be divided into two general categories: membership and non-membership corporations. In the case of a membership corporation, the members typically elect the directors. In the case of a non-membership nonprofit corporation, the board of directors is often self-perpetuating, i.e. the board of directors elects directors to replace those directors whose terms are expiring or who have resigned. Where the nonprofit corporation is part of a system of affiliated nonprofit corporations, directors often are elected by the board of a parent organization. Directors typically serve one to three-year terms. Frequently, terms are staggered so that a portion of the board is elected each year, thereby

[1] *The fiduciary duties of trustees of trusts are not within the scope of this handbook. Often, state law imposes a higher standard of care on trustees of trusts than on directors or trustees of corporations.*

assuring the nonprofit corporation of some continuity in its governing body.

Regardless of who elects them and whether they are referred to as "directors" or "trustees," the directors of a nonprofit corporation are charged by law with overseeing the affairs of the nonprofit corporation. Usually that authority is exercised, in part, through officers elected by the directors, committees appointed by the board of directors or the president of the nonprofit corporation, and staff persons hired by the nonprofit corporation. Because the directors act for the benefit of others, they owe certain fiduciary duties to the corporation they serve, often referred to as the "duty of care" and the "duty of loyalty," which are discussed below.

Some nonprofit corporations elect to establish an executive committee, usually composed of officers of the corporation, which is empowered to make specified decisions, such as those decisions necessary between board meetings. With the exception of executive committees, most committees of nonprofit corporations merely make recommendations for consideration by the board of directors.

Officers usually include a president, one or more vice presidents, a secretary and a treasurer. The bylaws of the corporation together with the governing state nonprofit corporation law specify the powers of each of the officers.

Nonprofit corporations are incorporated in one of the states of the United States or the District of Columbia (or another country), typically by filing in a public office a document usually called Articles of Incorporation or Certificate of Incorporation. This document, sometimes referred to as the Charter, establishes the corporation, specifies its purposes and may contain language appropriate to obtain the desired tax-exempt status. Nonprofit corporations also have a governing instrument called Bylaws or Regulations that should provide clear answers to questions regarding issues such as eligibility for and rights of membership; the process for nominating and electing directors and officers; standards and process for removing members, directors and officers; notice and quorum requirements for meetings of directors and members; the establishment and powers of committees; and the indemnification and limitation of liability of officers and directors.

A nonprofit corporation usually has a mission statement (often summarized in its Articles of Incorporation and Bylaws) defining the mission of the organization and the persons whom it intends to serve, sometimes referred to as the charitable class or beneficiaries. In many states, the attorney general has broad power to oversee the operation of nonprofit organizations, particularly those that are charitable in nature.

DUTIES OF DIRECTORS

DUTY OF CARE

The duty of care requires the director to be informed regarding the affairs of the corporation and to exercise the care that a prudent person in his or her position would exercise, and to do so in a manner that the director reasonably believes to be in the best interest of the corporation.

To fulfill his or her duty of care, at a minimum, a director should:

- Regularly attend meetings of the board of directors;
- Be informed about the affairs and finances of the corporation; and
- Exercise his or her independent judgment with respect to issues under consideration.

Board meetings should be held regularly; usually they are held monthly or quarterly. Meetings held only as the need arises are rarely satisfactory.

Directors frequently rely upon staff members to provide information regarding the affairs and finances of the corporation. In general, a director may rely upon information supplied by staff members, the corporation's legal counsel, public accountants or board committees, unless the director is aware that such information is not accurate or has other reason to believe that the information may not be reliable. If, however, sufficient information is not supplied, it is the director's duty to request additional information. The director should read written information that is provided.

Although the director may rely upon information provided by staff, he or she should exercise independent judgment and should not hesitate to take a position differing from that of the staff should he or she believe that to be appropriate.

State laws vary as to the factors a director may consider when evaluating a proposed course of action. For example, in considering whether a proposed course of action is in the best interest of a nonprofit corporation, in some states a director may, but is not required to, consider the effects of the proposed action on employees and contractors with the corporation, as well as the community in which the corporation is located.

DUTY OF LOYALTY

The duty of loyalty requires a director to exercise his or her duties in a manner that furthers the interest of the organization rather than his or her personal interest or the interest of another person or organization. Matters related to this duty include:

- conflicts of interest;

- corporate opportunity; and
- confidentiality.

A director should reveal to the board of directors any conflicts of interest that he or she may have when those conflicts or potential conflicts may be relevant. For example, if the corporation will be doing business with a company owned by the director or a family member, the board should be informed of that relationship. Similarly, if the director also serves as a director, committee member or employee of a competitor of the corporation, the board should be so informed.

If the board will be making decisions that present a conflict or potential conflict of interest, the affected director should answer any questions that board members have about the conflict and should abstain from voting on the matter. It is usually appropriate that the affected director leave the room while the matter is being discussed or considered so that other directors will feel comfortable in addressing the matter fully and frankly.

It is often advisable to obtain comparable information so the board has evidence that the transaction is fair to the corporation. The minutes should describe the disclosure of the conflict, any recusals and any comparable information on which the board relied.

A nonprofit corporation should have a written conflict of interest policy approved by its board. The policy should require each director to complete and deliver an annual disclosure statement identifying potential conflicts of interest, such as the director's employer, significant investments and other board positions. (Usually, similar information is also required for the director's family members.) The policy should also define a conflict of interest, identify all classes of individuals covered by the policy, and set procedures for (a) determining whether potential conflicts are actual conflicts and (b) approving transactions that are subject to a conflict. Typically, the president (or other presiding officer) of the corporation reviews the disclosure statements so that he or she will be generally aware of potential conflicts of interest.

A director is obligated to refer to the corporation business opportunities appropriate for the corporation prior to using them for his or her personal benefit. For example, a director desiring to purchase a parcel of real property that by its nature or location might be of interest to the corporation is required to permit the corporation the opportunity to acquire the property prior to purchasing it personally.

The director must not disclose to others confidential matters of the corporation. Any question as to whether any corporate information is confidential should be addressed to counsel for the corporation.

TYPICAL RESPONSIBILITIES OF DIRECTORS

The board of directors is charged with defining and overseeing the implementation of the organization's mission. The board is responsible for: i) developing and overseeing implementation of a strategic plan; ii) protecting the organization's long-term values and mission against sacrifice for short-term gains; iii) assuring that the programs operated by the organization are consistent with its mission; and iv) preserving the organization's assets against waste or abandonment.

Among the most important responsibilities of the board is selecting the person to serve as the organization's president, chief executive officer or executive director. An able leader allows the organization to deal effectively with most problems. With a weak or ill-suited leader, even good organizations will likely experience significant difficulties. The wise board of directors monitors the performance of its leader, providing periodic performance evaluations, while also serving as a source of advice and counsel regarding difficult issues to enhance the leader's effectiveness.

The board of directors approves the organization's annual budget (capital and operating) as well as modifications to the budget throughout the year. While staff can prepare and make recommendations regarding the budget, ultimately it is the directors who must make decisions regarding the addition of new programs and the making of capital expenditures. Should the organization experience financial difficulty, it is the board that must make difficult decisions such as the elimination of programs for the overall welfare of the organization and balancing the immediate needs of the organization's programs with the long-term financial well-being of the organization.

Auditors, attorneys and other professionals engaged by the corporation should be selected by and report to the board of directors, thereby providing comfort and assurance to the directors that the corporation is being properly and lawfully operated.

Finally, it is the responsibility of the board to oversee the management and investment of the organization's endowment and investments so as to assure the long-term viability of the organization and the availability of its resources, when needed. The board must assure that donations are invested and used in the manner required by donors and otherwise as required by law. In addition, in many organizations, it is expected that directors will actively assist in the organization's fundraising efforts, by donating to the organization as well as assisting the organization in obtaining donations from others. Indeed, many foundations and other organizations that typically make donations to charities are disinclined to support a charity where its directors do not contribute to the organization.

RIGHTS OF DIRECTORS

Most state nonprofit corporation statutes grant directors specific rights, typically including access to the books and records of the corporation, such as the financial records. Additionally, each director should have access to the corporation's key management staff; inaccessibility of management or unavailability of financial information should raise serious questions for the director regarding whether he or she will have the information necessary to carry out the director's duty of care.

Directors are also entitled to notice of meetings in accordance with the bylaws of the corporation and copies of the minutes of meetings of the board of directors and committees. In a well-run nonprofit corporation, the director can expect to receive prior to the board meeting a packet of information containing the minutes of the most recent board meeting, minutes of recent committee meetings, recent financial statements, an agenda for the meeting and information regarding matters to be considered by the board at the upcoming meeting.

In some states, applicable law grants the director standing to challenge in court corporate actions with which he or she disagrees.

ETHICAL ISSUES

In recent years, nonprofit organizations have been subjected to increased scrutiny as a result of scandals in the nonprofit world and business world and the passage of legislation commonly referred to as Sarbanes Oxley. With the exception of its provisions relating to document destruction and retaliation against whistleblowers, most of Sarbanes Oxley's requirements do not apply to nonprofit corporations. However, the standards set by Sabanes Oxley are becoming the accepted practice for nonprofit corporations. In some states, legislatures are considering adopting or have adopted Sarbanes-like requirements for nonprofit organizations. For example, some states now prohibit loans to directors or, for larger nonprofits, require an audit committee of independent directors (those without substantial personal financial or business transactions with the nonprofit). In that light, nonprofit corporations should consider the following actions:

1. Establishing an audit committee separate from the finance committee. The audit committee, which would be composed of persons not employed by the nonprofit and who are knowledgeable about financial matters, would make recommendations regarding the selection of the auditors, oversee the auditors, and establish processes for addressing complaints regarding accounting and internal control issues;

2. Establishing a nominating/governance committee composed of directors who are not employees. The committee would assume responsibility for nominating qualified candidates for directors, assuring that the board includes persons with necessary expertise, monitoring corporate governance, and monitoring compliance with ethical standards;
3. Establishing a policy regarding the retention and destruction of documents;
4. Establishing a whistleblower policy that allows employees to alert management and/or board to ethical issues and violations of law without fear of retaliation; and
5. Establishing a conflict of interest policy as described on page 9.

Finally, in light of the increased public and governmental scrutiny to which tax-exempt organizations are now subject, organizations that allow first class travel, resort accommodations and similar practices may wish to consider whether to retain such practices and should in any case carefully monitor such perquisites.

TAX EXEMPTION

In most cases, to be afforded the benefits of tax exemption, the nonprofit corporation must apply to the IRS for recognition of exemption. Many, but not all, nonprofit corporations qualify for exemption from federal income tax because they are described in one or more provisions of Section 501(c) of the Internal Revenue Code (“Code”). The most common status is that of a charitable organization described in Section 501(c)(3) of the Code, which affords both exemption from federal income tax and deductibility of charitable contributions to the organization. Generally, 501(c)(3) status is available to charitable, religious and educational organizations. Qualification under other provisions of Section 501(c) affords exemption from federal income tax, but generally does not afford deductibility of contributions to the organization.

When the IRS recognizes an organization as exempt under Section 501(c)(3), it also characterizes it as either a private foundation or a public charity. A 501(c)(3) organization is presumed to be a private foundation unless it qualifies as a public charity. For the reasons discussed below, ordinarily it is preferable to qualify as a public charity.

501(C)(3) PUBLIC CHARITIES

An organization described in Section 501(c)(3) may be classified a “public charity” if it is a hospital, church or school, meets a financial test demonstrating that it has broad public support or supports one or more publicly supported organizations.

Section 501(c)(3) public charities are subject to a variety of limitations on their operations, including prohibitions on:

- certain political activity;
- any substantial amount of lobbying; and
- allowing the assets or income of the organization to inure to the benefit of private persons.

CERTAIN POLITICAL ACTIVITY

A 501(c)(3) public charity is not permitted to engage in any political campaign activity in support of or opposition to any candidate for public office. Accordingly, directors who are inclined to involve themselves personally in such activity must be careful not to undertake such activity in their capacity as directors of the 501(c)(3) organization. For example, they should not conduct meetings at the organization's office space or use the organization's letterhead or e-mail system for political correspondence or purport to be speaking on behalf of the organization.

LOBBYING

A 501(c)(3) public charity may engage in lobbying only if the amount of the lobbying is not substantial ("Substantial Part Test"). Unfortunately, the Code does not define either "substantial" or "lobbying" for the purposes of applying the Substantial Part Test. Lobbying by directors for its causes is usually attributed to the nonprofit organization, even when the directors volunteer their efforts.

Some 501(c)(3) organizations are eligible to elect to be governed by a financial formula set forth in Section 501(h) of the Code instead of the Substantial Part Test. This election is particularly attractive to organizations whose volunteers lobby extensively for the organization's causes, because the formula used is based on the organization's expenditures and, unlike the Substantial Part Test, does not take into consideration volunteer activity not involving organization expenditures. Regardless of which test is applicable, a nonprofit corporation must conduct its affairs in a manner that does not result in prohibited excessive lobbying.

INUREMENT

A 501(c)(3) public charity is expected to operate for the benefit of the public and the charitable class served by the organization, rather than the benefit of private persons. Transactions between directors (and other private persons as well) and the exempt organization must be structured in a manner that does not improperly benefit the private person. Such improper benefit to private persons is referred to as "private inurement." Private inurement can occur in numerous different ways. For example, the organization may not do business with a key employee or an affiliated business corporation unless the terms are arm's-length. Ordinarily, this would mean that the organization has determined that the transaction is a sound business decision, and fair to the charity.

Similarly, the exempt organization cannot pay excessive compensation, pay for services that are not provided or provide free or below-market price goods or services to private persons other than members of the charitable class the organization serves. This prohibition on private inurement frequently raises significant issues for 501(c)(3) organizations desiring to participate in partnerships with taxable entities or individuals.

INTERMEDIATE SANCTIONS/EXCESS BENEFIT TRANSACTIONS

A "disqualified person" who engages in an "excess benefit transaction" with a 501(c)(3) organization that is a public charity or with a 501(c)(4) organization can be subject to an excise tax of 25% of the excess benefit, and, if correction of the excess benefit is not timely made, to an additional excise tax of 200% of the excess benefit. Officers and directors who knowingly participate in such a transaction may be subject to an excise tax of 10% of the excess benefit (capped at a $20,000 aggregate excise tax for all directors) because it is an intermediate option to the more draconian revocation of exempt status. These excise taxes are commonly referred to as intermediate sanctions because the penalty taxes are an intermediate option to the more draconian revocation of exempt status.

"Disqualified persons" are persons with substantial influence over the exempt organization. They include officers and directors of the public charity and persons in positions of authority with the public charity during the previous five years, as well as their family members and companies owned by them. In an “excess benefit” transaction, the value of the economic benefit conferred by the exempt organization exceeds the value of the consideration it receives. Potential excess benefit transactions include (but are not limited to) compensation decisions affecting officers, directors and key employees, and transactions involving the sale of property between a public charity and one of its managers or employees.

A transaction may be presumed not to involve any excess benefit if:

- It is approved by a committee or board comprised entirely of disinterested directors;
- When valuing the benefit conferred by the charity, the directors used comparable information as a guide; and
- The directors properly documented their decision-making process.

501(C)(3) PRIVATE FOUNDATIONS

Private foundations are subject to more scrutiny and regulation than public charities. Like public charities, private foundations are subject to the above-described prohibitions on political campaign activity and private inurement. In addition, the private foundation is subject to an absolute prohibition on lobbying and significant additional restrictions on its operation and its relationships with its directors.

Self-dealing restrictions in the Code effectively prohibit many, if not most, business transactions between a private foundation and its directors and other persons who are "disqualified persons."[2] In addition, the law i) substantially restricts persons to whom and purposes for which grants may be made; ii) imposes limitations on the investments and holdings of the organization; iii) subjects the organization's investment income to an excise tax; and iv) requires the organization to make a certain amount of qualifying distributions (grants) each year. Because these restrictions carry with them punitive excise taxes for both the organization and involved director, a director is well-advised to know whether the organization he or she serves is a public charity or a private foundation. If the organization is a private foundation, the director must be familiar with the restrictions provided for in Chapter 42 of the Code. Ordinarily, a private foundation requires ongoing advice from an attorney or other tax professional knowledgeable regarding tax issues related to private foundations.

OTHER 501(C) STATUS

Many nonprofit organizations not described in Section 501(c)(3) of the Code enjoy exemption from federal income tax under other provisions of Section 501(c). For example, trade associations and chambers of commerce are usually exempt under Section 501(c)(6); civic and social welfare organizations enjoy an exemption under Section 501(c)(4); and certain social clubs qualify under Section 501(c)(7). There are some 28 categories of 501(c) organizations, each of which has its own set of requirements. Many differ substantially from those applicable to 501(c)(3) organizations.

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[2] *Disqualified persons include officers and directors and substantial contributors to the private foundation, as well as certain family members of and businesses owned by such persons.*

UNRELATED BUSINESS INCOME

The exemption from federal income tax does not extend to revenues generated from a regularly carried on trade or business the conduct of which is not substantially related to the exempt purposes of the exempt organization. To be substantially related to the organization's exempt purpose, the activity must directly further such purpose. Merely generating funds that are ultimately used for the organization's exempt purposes does not directly further the organization's exempt purposes. Revenues from such a trade or business are referred to as unrelated business income and may be subject to the unrelated business income tax.

The Code provides numerous exceptions and modifications for various categories of income that would otherwise constitute unrelated business income, including for example, interest, dividends, certain rents and royalties. To avoid unrelated business income, the exempt organization must satisfy the requirements relevant to the applicable exception or modification. Often these requirements are complex.

The determination of whether any particular revenue is unrelated to the exempt organization's exempt purposes depends upon the facts and circumstances of the case at hand. Income constituting exempt purpose income for one organization or under one set of circumstances may be unrelated business income for another organization or in other circumstances.

An exempt organization that has unrelated business income is required to file IRS Form 990T and pay any applicable tax on the income. In addition, because an exempt organization is required to operate primarily in furtherance of its exempt purposes, large amounts of revenue from activities constituting an unrelated trade or business may cause loss of the organization's exempt status.

AVOIDING THE FUNDING OF TERRORISM

Since the attacks on September 11, 2001, charities and government have shared the common interest of assuring that charities do not intentionally or inadvertently fund terrorism. In 2001, the Patriot Act amended several federal statutes to grant the President power to freeze or confiscate the assets of a charity believed to be contributing funds to persons listed by the government. To avoid inadvertently funding terrorism, a charity should check the names of grantees and their boards and affiliates against lists of terrorists maintained by the U.S. Treasury and U.S. Department of State. A charity should also undertake a pre-grant inquiry sufficient to become comfortable about the grantee, monitor the grant on an ongoing basis, require periodic reports and require the grantee to certify that it does not fund terrorism and is not associated with terrorists. Funding persons on the government's list can result in substantial criminal fines, jail time, freezing and confiscating of assets and loss of tax exemption.

TAX RETURNS

With limited exceptions, all public charities are required to file an annual Form 990, 990 EZ or 990 N with the IRS. (Private foundations file Form 990PF, instead.) Failure to file can result in financial penalties and loss of 501(c)(3) status. The Form 990 contains extensive information regarding the organization's governance and compensation practices, in addition to the usual financial information. To enable the charity to properly complete the Form 990, each director will need to disclose information to the charity regarding his or her direct and indirect financial relationships with the charity and with other directors and past directors. In addition, the board or appropriate committee (consistent with IRS guidelines) should review the Form 990 prior to filing as part of its governance oversight of the nonprofit.

LIMITATIONS OF SECTION 501 STATUS

Many benefits arise out of qualifying for one of the many exemptions afforded by Section 501(c) of the Code. The organization's revenues are exempt from federal income tax to the extent they arise from its exempt purposes. Contributions to 501(c)(3) organizations may qualify as charitable deductions. The organization may have access to tax-exempt financing and state exemption, preferred postage rates and similar benefits. However, exemption under Section 501 of the Code does not necessarily afford the organization exemption from all taxes and reporting requirements:

- It does not exempt most organizations from filing an annual information return with the IRS, which must be made available to members of the public upon request.
- It does not exempt the organization from paying FICA and certain other employment-related taxes imposed upon employers.
- The organization may still be required to report and pay federal "unrelated business income tax" on taxable income derived from activities not related to its exempt purposes.
- It does not necessarily operate to exempt the organization from state income taxes. The organization must identify those states where it will be operating and determine what action, if any, is necessary to qualify for exemption in each state.
- In many states, it does not operate to assure the availability of exemption from real property taxes or sales and use tax on items purchased by the organization.
- It rarely operates to allow the organization to avoid collecting and paying sales and use tax on taxable items or services it sells, even if the sale furthers the organization's exempt purpose.
- It does not exempt the organization from most federal excise taxes.

SOLICITING CHARITABLE CONTRIBUTIONS

Most states regulate by statute and/or regulations solicitations for charitable contributions. Although the statutes vary greatly, typical requirements include registration with a governmental body such as Department of State or Attorney General (unless the organization qualifies for an exemption) and the disclosure of specified information to the donor at the time of solicitation. Some states also require the placement of a legend on solicitation materials.

The number of exemptions and their requirements vary greatly from state to state; some states have no exemptions. Typical exemptions include religious organizations, organizations raising less than a specified amount of funds and certain veterans organizations. Before soliciting in a state, a charity should determine what steps are necessary to comply with requirements for the solicitation of charitable contributions. Some fundraising activities (such as charitable gift annuities) may also be affected by state securities or insurance law or by local licensing requirements. Other fundraising activities (such as some small games of chance) may be subject to special state or local regulation and may generate taxable income.

Many states also regulate professional solicitors (those who are paid by the nonprofit organization to solicit funds), professional fundraising counsel (those who provide advice regarding how to raise funds or establish fundraising programs), and/or commercial co-venturers (businesses advertising that the purchase of goods or services from the business will benefit a charity). Some states require that charities engaging or working with such persons do so in written contracts approved by the state.

Charities that receive restricted donations are ordinarily required to use them for the purposes specified by the donor, absent court approval to the contrary. Among the duties of directors is assuring that use of such restricted funds complies with the donor's restrictions. Directors will also ordinarily be charged with assuring that the nonprofit corporation's endowment is invested and used prudently and in accordance with state law. Some states place limitations upon the use of income from endowment funds.

THE NEW DIRECTOR

Before his or her term begins, the new director should undertake to become knowledgeable about the organization. The director should review the organization's:

- articles of incorporation and bylaws
- determination letter from the Internal Revenue Service
- most recent tax return
- most recent audited financial statements or year-end statements if audited financial statements are not available
- most recent annual report
- list of the current officers and directors of the organization
- summary of applicable insurance (including a review of any policies of Directors and Officers Fiduciary Liability Insurance)
- mission statement
- chart showing the relationship among the organizations, if the organization is part of a system of affiliated organizations

This information will serve to familiarize the director with the organization and assist him or her in understanding the organization and assessing any risk that he or she may be assuming.

Many nonprofit organizations have elected to reorganize themselves into systems of affiliated nonprofit organizations. A typical simple structure includes a parent organization that establishes policy for the entire system, a subsidiary organization that operates the charity's program and a subsidiary organization that raises and invests the charity's funds. Sometimes, the system also includes other nonprofit organizations and a business corporation owned by one of the nonprofit corporations. Normally, each of the nonprofit corporations in the system qualifies as an organization exempt from federal income tax. Directors for a corporation that is part of a reorganized system face the additional challenge of becoming familiar with the role of the corporation within the system and understanding the relationship between and among the various corporations comprising the system.

UNDERSTANDING THE FINANCIAL STATEMENTS

Like a business corporation, a nonprofit corporation's financial statements currently should include, at least, a profit and loss statement and a balance sheet. The balance sheet reflects the assets, liabilities and fund balance of the nonprofit corporation on any particular day. The profit and loss statement shows the performance of the organization during the time period covered by the profit and loss statement. Often there is a cash flow statement that will enable the director to link the profit and loss statement to the balance sheet. Accounting rules require nonprofit organizations to identify net assets as unrestricted, temporarily restricted or permanently restricted.

Many nonprofit corporations use a system of accounting referred to as fund accounting. Fund accounting is a system of accounting in which separate records are kept for assets donated to a nonprofit corporation which are subject to restrictions imposed by donors or outside parties. Assets with similar restrictions are usually commingled in logical groupings described as "funds" and are accounted for together rather than separately. A balance sheet and an operating statement for each fund can be prepared from the accounts of each fund.

There are no limits on the number of funds that a corporation may use, but corporations generally use the following five categories of funds: i) general fund; ii) restricted fund; iii) endowment fund; iv) board-designated endowment fund; and v) fixed asset fund. The general fund contains no restricted assets and is used by the board to carry out the general activities of the corporation. The restricted fund contains assets that the corporation must use for specified purposes. The endowment fund contains assets for which the donor has stipulated that only the income earned can be used. The board-designated endowment fund contains assets that are restricted by board action as opposed to donor stipulation. The fixed asset fund records the cost of fixed assets.

Financial statements should be provided to the directors at each meeting of the board, and appropriate staff members should be available to answer questions regarding the financial statements. Expense permitting, the financial statements should be audited or reviewed annually by a person outside the organization. Often funding sources or laws applicable to charitable solicitation will require an audit or review.

Directors should assure that the corporation's auditors are truly independent, establishing a mechanism whereby the directors have direct access to the auditors' help to assure independence. Directors should satisfy themselves that an appropriate internal control structure is in place to avoid misuse of assets. Also, accounting rules specific to nonprofit organizations cover recognition and evaluation of certain gifts and may require expert advice. Boards not having any directors with sufficient expertise in such matters may wish to seek professional advice regarding such matters.

RISK REDUCTION

Although suits against directors of nonprofit corporations occur less frequently than those against directors of business corporations, they are not unknown. In recent years, widespread publicity and, in some cases, criminal convictions have highlighted the fiduciary role of directors and officers of nonprofit organizations.

A variety of tools is available to reduce the risk that a director will be held liable for his or her actions or omissions:

- Directors and Officers Liability Insurance
- Other appropriate insurance
- Indemnification
- Limitation of Liability

Many nonprofit corporations purchase directors and officers liability insurance to protect their fiduciaries. While such insurance is useful, exclusions from coverage, deductibles and copayment amounts may operate to reduce the protection provided by D&O insurance. A director should be familiar with the limitations of the policy provided by the organization.[3]

[3] *If the organization does not carry directors and officers liability insurance, the director may wish to explore obtaining such coverage himself, perhaps through homeowner's insurance or an umbrella policy.*

The organization should carry insurance appropriate to its activities (including, for example, general liability, errors and omission, automobile or malpractice) in amounts sufficient to meet its needs. The absence of appropriate insurance may cause an injured person to seek recourse from directors. If adequate insurance is in force, an injured person is less likely to seek damages from a director.

State statutes often identify the circumstances in which a nonprofit organization may indemnify a director. The board may decide, in advance of a particular event, what protections the corporation should offer. These protections should be embodied in the Bylaws or Articles or Certificate of Incorporation of the corporation. The indemnification obligation may include reimbursing and/or advancing legal fees incurred in defending a proceeding as well as damages actually assessed against the director. Sometimes organizations also enter into contracts with directors or officers to indemnify them under specified circumstances.

Some states allow a nonprofit corporation to limit the liability of its directors. If the state in which the corporation is incorporated so permits, such a provision should be included in the appropriate governing documents.

In addition, under many circumstances, the Volunteer Protection Act of 1997 limits the liability of volunteers serving nonprofit organizations.

CHECKLIST

The following checklist is intended to assist directors in reducing their risk and to assist the organization in fulfilling its obligations under the law.

- Is the organization actually incorporated?
- Does the corporation have clear bylaws?
- Does it conduct its affairs in a manner consistent with its bylaws?
- Does the board meet regularly?
- Are the other directors respected members of the community?
- Can I devote the time necessary to carry out my duties?
- Does the corporation have a conflict of interest policy?
- Do I have any significant conflicts of interest that will impair my ability to serve this organization?
- Does the corporation have directors and officers liability insurance and, if so, what are the policy limits, exclusions, deductibles and copayments?
- Does the corporation maintain sufficient insurance appropriate to its activities?
- Do the bylaws or other governing documents provide for indemnification and under what circumstances and with what limitations?

- Do the bylaws or other governing documents provide for limitation of liability?
- Does the organization produce regular financial statements and are they audited annually?
- What internal financial controls are in place?
- What restricted gifts does the organization have and how are they being used?
- How is the endowment invested and used?
- What is the federal tax status of the organization?
- Is the organization a private foundation or public charity?
- If it is a private foundation, what steps are taken to comply with the regulations imposed on private foundations?
- Has the organization filed its federal tax return?
- Is the organization paying its employment taxes?
- Does the organization engage in lobbying or political activity?
- Is the organization paying sales tax on items it buys and collecting and remitting it on items it sells?
- Is the organization authorized to solicit contributions in each jurisdiction where it does so?

SUMMARY AND CONCLUSION

Nonprofit corporations today constitute a significant portion of the United States economy. Persons serving as officers and directors of nonprofit corporations perform valuable services for these organizations, the people and causes served by these organizations and the community at large. Usually, the only "compensation" received is the associated prestige and the satisfaction of contributing to the well-being of society. Notwithstanding this limited "compensation," persons serving as officers and directors can expose themselves to potential liability and/or embarrassment or reputational injury. The wise director will carry out fully his or her duty of care and duty of loyalty. The wise nonprofit corporation will put into place appropriate vehicles to limit the liability of its directors and otherwise reduce the likelihood that the corporation's problems will become those of its directors.

K&L Gates LLP has prepared this handbook as a service to the nonprofit community and the many individuals who serve as directors of nonprofit corporations. It summarizes the duties of directors of nonprofit corporations, provides general background information regarding selected available federal tax exemptions and laws regulating charitable solicitations and provides practical advice for minimizing liability arising out of service as a director of a nonprofit corporation. It is not intended to serve as legal advice on any particular matter. Users should consult counsel knowledgeable about nonprofit corporations for legal advice.

This handbook applies to nonprofit corporations engaged and doing business in the United States. It does not apply to nonprofit organizations or charities engaged or doing business in any other jurisdiction, including without limitation, the United Kingdom.

This handbook was conceived of by originating author and former K&L Gates Partner, Susan M. Mussman Schwartz, Esq., and is updated by members of the Tax Exempt Organizations practice group at K&L Gates.

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