insights

Governance of 501(c)(3) Organizations:

Understanding the role and responsibilities of board members.

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In today's environment of increased regulatory requirements, greater public scrutiny and fluctuating markets, the trustees and directors of nonprofit organizations face greater demands. While serving on the board of a nonprofit organization can be a rewarding experience, the expected responsibilities, roles and functions should be well understood before agreeing to serve.

what is governance?

Board members are the governing body of an exempt organization and involved in the management, guidance and decision-making processes on behalf of the organization they represent. The role is considered both an honor and obligation that should be taken seriously upon acceptance. The following are some of the recommended policies and practices for individuals in this role.

mission

The governing body is responsible for adopting and reviewing a clearly-stated mission, including the organization's purpose and goals. It should also include activities the charity will undertake, where they will take place, and for whom.

governing documents

Organizational documents supply the framework for a charity's governance and management. State law determines the type of document required and its contents. A trust agreement or declaration of trust is the governing document for a trust. Articles of incorporation are used for a charity structured as a corporation. Some states may also require corporations to adopt bylaws.

Upon completion of the governing documents, the nonprofit organization may submit an application for exempt status to the IRS with either Form 1023 or 1024, including any necessary attachments. The IRS will then issue a determination letter that states the type of exemption status for the nonprofit organization. It is important to note that any significant changes to the governing documents or bylaws of the exempt organization should be reported on its federal tax return.

governance and management policies

Although organizations are not required to have written governance and management policies, according to the Internal Revenue Code, the IRS looks for full transparency of an organization's operations. Evidence of this can be seen with the information required to complete Form 990, which was revamped by the IRS in tax year 2008. The following are the major governance and management policies most boards need to consider:

Compensation: Executive compensation is a significant decision for the governing body, which should have a formalized compensation review and approval process in place. The IRS will likely scrutinize any compensation to an individual that exceeds $150,000. Form 990 requires additional information to be provided on Schedule J in these cases so use

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of the "rebuttable presumption test" is recommended. This test considers compensation to be reasonable when:

- The compensation is approved in advance by an authorized body of individuals with no conflict of interest toward the arrangement.
- The authorized body used comparability data in making its decision.
- The authorized body documented the basis for its determination.

Conflict of Interest Policy: The duty of the governing body is to avoid conflicts of interest to demonstrate loyalty and act in the best interest of the organization. A "Conflict of Interest Policy" should contain written procedures that determine when there is a conflict of interest, and include a course of action should an event occur. The policy should be periodically monitored and reviewed.

Investments: Directors have a fiduciary obligation regarding the investment activity of the organization. As such, they are held to a higher standard of prudence in exercising control over investment decisions. It is important for an organization to draft a formal investment policy statement and spending policy to clearly document its risk profile, long-term investment roadmap, and annual cash needs. These guidelines are especially important to help evaluate whether the organization should invest its money in certain complex investments, such as alternative investments or other investments that may conflict with the exempt purpose of the organization.

Fundraising: The governing body is held accountable for monitoring the methods used to raise funds on behalf of the organization. These activities should be monitored to ensure they comply with federal and state laws and that the costs of conducting these activities are not excessive. Members of the governing body are usually called on to be actively involved in raising funds, which may include serving as a representative, assisting in the organization of a fundraising event, hosting a benefit, or making a personal contribution.

Documentation of Meetings and Decisions: The governing body should maintain written minutes of all meetings and actions taken. Establishing a written document retention and destruction policy is suggested for all records, including electronic and paper material.

Code of Ethics: The governing body has the responsibility of establishing ethical standards for the organization. These standards should clearly state the behaviors that are encouraged or discouraged within the organization, and include a policy for handling complaints and/or violations in a confidential manner.

oversight and transparency

The governing body is responsible for overseeing the organization's financial statements to ensure its financial resources are used to further the organization's charitable purpose. It should regularly receive and review the organization's financial statements, auditor letters, finance and audit committee reports, and Form 990.

Form 990 has been greatly revised over the past few years and is now more thorough in its quest for information. Although this review is not a requirement in the Internal Revenue Code, it is in the best interest of the charitable organization for the governing body to be familiar with the information requested on the return. This helps keep the board responsive to IRS expectations.

The following documents must be available for public inspection:

- Form 990 for the three previous years and Form 990-T, if applicable
- Form 1023 Application for Exemption
- The determination letter received by the IRS

The organization confirms its commitment to honest and open administration and shows its devotion to achieving its charitable purpose by making available all information concerning its mission, activities, finances and governance and by being open to inspection in this manner.

when can an exemption be revoked or modified?

It is possible for an organization to have its exemption revoked or modified by the IRS. If this happens, the organization would receive a ruling or determination letter from the IRS. This would result from:

- A material change in the organization's character, purpose, or the method of operation that is inconsistent with its exemption.
- The organization presented inaccurate material as factual representations.
- The organization engaged in a prohibited transaction, such as diverting corpus or income from its exempt purpose.
- An enactment of legislation or ratification of a tax treaty.

when is a board member liable?

If governing board members abuse their fiduciary responsibilities, they may be subject to civil or criminal penalties, especially if they benefited from their actions or inactions. Under some circumstances, directors, officers, and volunteers of non-profits may be protected by statutory and other limitations on liability and legal expenses, although these protections are quite varied. Each state may have its own standards.

Governing board members may be liable for damages for failure to perform their duties in accordance with state statutes if it can be proven that they did not act in good faith. They may also be liable for damages for any act that they take or fail to take as a board member if it can be proven that there was deliberate intent to cause injury to the organization.

how can board members protect themselves from liability?

Directors, officers and volunteers of nonprofit organizations may be protected by statutory and other limitations on liability and legal expenses under some circumstances. In order to manage risk and responsibilities, boards may consider maintaining a few priorities.

Board members should manage the organization with the mission in mind and clearly document that effort. This includes maintaining written documentation of policies and establishing a schedule for review. Minutes of meetings should be recorded to demonstrate the efforts of the board to fulfill their fiduciary duty. In addition, board members should create a formal budget, investment policy statement, and spending policy. They should hire professional partners who work specifically with nonprofit organizations and seek their assistance in drafting these documents. These partnerships should include a commitment to a regular cycle of updates for these vital guidelines.

It's also important for board members to work with professional and advisory partners who understand fiduciary duty and build their business on serving nonprofit organizations. These partners can provide the board with the latest thinking on critical issues for nonprofit organizations and advise them as they make decisions. Furthermore, by hiring specialists, the board may delegate some of its decision-making power to partners who specialize in services that are crucial to fulfilling the organization's mission. For example, an organization may hire an accounting firm with a specialty auditing team that has experience working with organizations with a similar mission. Hiring a firm with this type of experience can help ensure that systemic weaknesses are identified in the course of an audit.

Finally, board members may want to consider additional insurance coverage to afford broader protection for the organization, as well as its directors and officers. There are two types of insurance coverage available: D&O Liability Insurance and Employment Practices Liability Insurance. D&O Liability Insurance covers directors and officers for claims arising from their acts, omissions or decisions. Employment Practices Liability Insurance offers coverage for claims of discrimination.

summary

It's important for individuals who are considering serving on the board of a nonprofit to understand the role, responsibilities and functions they will be accepting with the position. While the role may seem challenging to some, it can be a tremendous source of fulfillment and satisfaction for individuals who are passionate about an organization's mission and willing to invest their time and expertise on behalf of the organization.

For more information about how the NonProfit Services team can assist you with these strategies, contact your local Relationship Manager.

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