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GUIDANCE FOR NONPROFIT BOARD SERVICE

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Fiduciary Duties and Mistakes to Avoid

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This presentation is limited in scope and intended to provide a brief and inspiring guideline to a deeper exploration of the stewardship responsibilities that accompany the privilege of serving as a director of a nonprofit organization. The true focus of this presentation will be on charitable nonprofits, although other nonprofit organizations exist.[1] The distinction between the various types of nonprofits is primarily that contributions to a charitable nonprofit organization that is recognized as a §501(c)(3) entity under the Internal Revenue Code will qualify for a charitable deduction by the donor. Charitable nonprofit organizations hold their assets for the benefit of the public and stewardship over such assets by the organization is essentially a public service and can be likened to trustee status at common law.[2]

[1] IRS Publication 557 (Rev. January 2018) Cat. No. 46573C Tax-Exempt Status for Your Organization

[2] Note the distinction between trustee-like status of the organization, as compared to trustee status of individual directors. The law is clear that directors of a nonprofit organization are not subject to the same fiduciary duties as a trustee at common law. BOC §22.223. From a practical perspective, does application of the facts to the law result in a discernable distinction?

A. Fiduciary Duties of Directors of Nonprofit Organizations

1. Texas Business Organization's Code

In Texas, the Texas Business Organization's Code ("BOC") guides or prescribes the conduct of any corporate board, whether it be for profit or nonprofit. Chapter 22 contains most of the statutory provisions affecting nonprofit organizations ("NPOs"). With regard to procedural matters, such as notice requirements for board meetings, the BOC gives deference to the governing instrument(s) of the organization and in the absence of provisions in the bylaws, the BOC will control. In other arenas, the BOC mandates legal requirements. It is wise, and arguably necessary, for directors to familiarize themselves with the law in aid to the practical guidance provided by the NPO's certificate of formation and bylaws.

Attorneys who sit on nonprofit boards should consider whether they represent the board and/or are expected to provide legal guidance. If an attorney has specifically disavowed such representation, the minutes should clearly reflect this to avoid the potential for heightened liability.

2. Duties of Directors

The duties of directors of a NPO's board are commonly, and frequently, referred to as the duties of care, loyalty and obedience, as is prescribed at common law.

BOC §22.221 states that:

> "a person seeking to establish liability of a director must prove that the director did not act:
> (1) in good faith;
> (2) with ordinary care; and
> (3) in a manner the director reasonably believed to be in the best interest of the corporation."

Practically speaking, what does this mean? These duties can reasonably be construed together to mean that a director has a duty to genuinely try to do the right thing for the mission of the organization and to do so with the amount of care an ordinarily prudent person in a similar position would exercise under similar circumstances. Have you done your homework and secured information to satisfy yourself that your input is in good faith, or have you merely relied on the explanations provided by your executive director without supporting documentation? Have you reviewed financial information or merely been advised that the organization is in great shape? Have you studied the mission of the organization and determined that expenditures are proper and in line with that mission? As for the duties of loyalty and obedience, have you acted for the benefit of the mission of the organization or will your acts result in

benefit to you, your personal business, a friend/family member, or other individual or entity whom you'd like to assist"? The questions are simple and support one simple premise—a director must appropriately steward the assets of the nonprofit organization she serves.

B. Mistakes to Avoid

The mantra for any charitable nonprofit director should be, "Am I appropriately stewarding the public's money"? This prevailing principle guides the role and actions of a director. The organization's funds, which were gifted (with our without a specific solicitation from the organization) are given for a charitable purpose. Gifts made to a charitable, nonprofit organization without specific restriction, must be expended for the organization's purpose and done so reasonably with consideration given to both the advisability of the current expenditure and the prudency of investment for income potential. Expenditures should be made, as needed and prudent, and should consider the overall fiscal strength of the organization as well as the proportionate balance between expenditures made for direct, mission-related program services and expenditures for reasonable and necessary operating expenses (including compensation). Funds gifted with restriction as to specific purpose or duration must be expended for that specific purpose and/or held for the necessary duration, including perpetuity.[3]

Individuals who serve on boards of directors for nonprofit organizations often do so for altruistic and noble reasons. Innocent mistakes in judgment can and do occur. Ignorance, however, is not a defense to allegations of breach of the fiduciary duties that accompany nonprofit board service. The legal standard requires good faith, due care, loyalty and obedience, thus requiring a director be active and informed in service to the organization's mission.

How then, can you avoid mistakes? Start by knowing your organization. Most of the duties and responsibilities turn on seeking and considering adequate information to inform your decision-making. Obtain training in the basics of nonprofit board service.[4] Engage in the best practices espoused by other successful nonprofits. Subscribe to and read nonprofit newsletters. The possibilities are endless!

[3] Endowed gifts held by charitable organizations given with an intention they be held in perpetuity are charitable trusts. The rule against perpetuities does not apply when dealing with "charitable trusts." Tex. Prop. Cd. §112.036.

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[4] A number of sources/entities exist throughout the state offering nonprofit board training. Austin Community College's Center for Nonprofit Studies conducts ongoing courses open to the general public. The State Bar's "Governance of Nonprofit Organization's" annual course is typically held in August of each year.

In addition to highlighting the minimum effort expected of you as a director, this paper is intended to emphasize some of the more common (Top Ten!) missteps that this author has witnessed over her lengthy career in public service as the individual primarily responsible for the regulation of charitable trusts and nonprofit corporations, while with the Office of the Texas Attorney General. To know and avoid these mistakes is the first step in implementing recognized "Best Practices" in the arena of nonprofit organization governance. A goal all nonprofit directors share.

1. **Let the tail wag the dog—Executive Director in Control of the Board**

   It is all too common in an organization conceived and founded by a dedicated individual of noble intent, for that individual to serve as the self-proclaimed executive director. Most commonly, this is a paid position with the organization. It is not uncommon for expenditure on the executive director's salary to precede and exceed expenditure of the public's donations for mission-based projects in a nonprofit organization's initial years of operation. On the flip side, founder-established organizations are often initially "funded" by the founder herself, and the influx of this funding is left undefined. Without contemporaneous and adequate paperwork to evidence that these funds are given as a loan, the terms of which are documented, such funds will constitute a charitable donation to the organization and cannot be paid to the founder later in time as repayment of a loan, as compensation, or otherwise.

   In a founder's syndrome scenario, the "founder" will typically appoint the initial board members whose responsibility it is to assume the duties of managing the organization as prescribed by the BOC, §22.201.[5] Such a situation may (and often does), result in a board of directors that is either asleep at the wheel or placing blind trust in the organization's self-declared leader. Such a situation often results in little to no election of new directors as years pass by and operations remain in the hands of the founder without sufficient oversight.

   To reiterate, as a director, it is your responsibility to know what you know and what you don't know about the operations of your organization and seek out and consider both proffered explanations and supporting documentary information from the managers that your organization employs. Blind acceptance is insufficient to

[5] Founder's syndrome (also founderitis) is a popular term for a difficulty faced by organizations where one or more founders maintain disproportionate power and influence following the effective initial establishment of the project, leading to a wide range of problems for the organization..wikipedia.org/wiki/Founder's_syndrome
A Google search of the phrase "founders syndrome nonprofits" yielded 7,370,000 results! A plethora of warnings and analyses exist on this known phenomenon responsible for the destruction of many organizations at the hands of their creator. I encourage you to read a minimum of one or two of these resources.

constitute ordinary care. Although an officer, such as the executive director, shares in liability for his or her acts,[6] it is important to remember that the board of directors is ultimately responsible for managing the affairs of the corporation.

2. Fail to adopt *and follow* policies and procedures.

Adopting policies and procedures is just good sense. You can't manage the affairs in a reasonable manner if there are no rules. Established policies, as to expenditures, fiscal checks and balances, expense reimbursement, conflicts of interest, gift acceptance, and others, are necessary best practices to nonprofit management. More importantly, once you have established policies, follow them. It is much more difficult to exhibit good faith if you have a policy, but you do nothing to follow or enforce it. State regulators look for policies and for evidence that those policies were followed. For guidance on the policies of interest to the IRS in the arena of governance, simply review a 990 tax form.[7]

3. Fail to maintain bylaws and minutes.

Bylaws and minutes are required by the BOC. BOC §22.102, BOC §3.151. These documents will be among the first documents any regulator will wish to review. Don't minimize the importance of minutes! This is the place to evidence your involved stewardship, and your dissent to actions that the majority of the board takes with which you disagree. Make the most of it!

4. Fail to know the minimal requirements under the law.

There are many "necessary" compliance measures that are important to both maintaining status as a 501(c)(3) organization (for example, filing of your annual information 990 tax form), and maintaining status as a corporation in good standing with the Texas Secretary of State (for example, filing your periodic report). As mentioned earlier, there are also basic requirements mandated by the Chapter 22 of the BOC and some of the provisions of the BOC applicable to all "filing entities." Reasonable oversight of some of the more technical requirements of the law may

[6] BOC §22.231

[7] -Conflict of Interest Policy (Part VI, Section B, IRS 990)
-Executive compensation approval process (Part VI, Section B)
-Document Retention and Destruction Policy (Part VI, Section B)
-Gift Acceptance Policy (Schedule M)
-Meeting minutes document practices (Part VI, Section A)
-Review process of Form 990 by the Board of Directors (Part VI, Section B)
-Whistleblower Policy (Part VI, Section B)
-Joint Venture Policy, if applicable (Part VI, Section B)
-Policies regarding chapters, affiliates, and branches, if applicable (Part VI, Section B)

occur and be easily corrected. Other oversights, however, may be "fundamental" and lead to embarrassing and potentially harmful consequences for the organization. Although an informed executive director is responsible for technical compliance, an uninformed board of directors which fails to recognize crucial mistakes will not escape liability.

By way of example (and not intended to be a complete list):

- A minimum of 3 board members are required. BOC §22.204.
- Dividends to directors, officers or members are prohibited. BOC §22.053.
- Loans to directors are prohibited. BOC §22.225.
- Annual filings of income returns (990s) to IRS are required, regardless of income. Failure to file for 3 years in a row results in automatic revocation of tax exempt status. The IRS wants to know (there's a specific question on the 990!) if the Board has reviewed the 990 before it is filed.
- Certificate of Formation must be filed with Secretary of State for nonprofit corporate status recognition. Obtaining IRS 501(c)(3) status does not establish state recognition as a nonprofit organization. The nonprofit organization is responsible for filing Periodic Reports as required by the SoS. Registered agent information should be kept current with SoS.
- Raffles are illegal gambling unless conducted in strict accordance with the Charitable Raffle Enabling Act. (§2002.001 Tex. Occupations Code)
- Although Texas does not have general charitable registration, certain types of organizations must register in Texas before soliciting. (veterans and law enforcement entities, for example.)
- Tax exemptions are not automatic. Sales/franchise/property taxes require recognition by the applicable state taxing authority.
  https://comptroller.texas.gov/taxes/publications/96-1045.php
  and see your county appraisal district's website.
  You must conserve your organization's funds and the expenditure of unnecessary amounts in tax merely because you failed to complete paperwork creating/maintaining your tax-exempt status is simply not good stewardship, and arguably a breach of your fiduciary duties.

5. Spend/Borrow from restricted funds for undesignated purposes.

Don't do this. Restricted funds are not funds for general operations of the organization and can typically only be spent for the designated purpose unless proper legal proceedings are initiated. (See f.n.10, ahead.) If the organization has redirected the funds away from their restricted purpose, even with good intent to pay them back, this violates the gift. Should the organization then dissolve or file for bankruptcy, the directors will be liable for the misdirected funds. In bankruptcy, a nonprofit

organization's restricted funds are not part of the debtor's estate and are not available to pay creditors, as the organization holds the funds as a separate "trust" for the specific purpose/duration designated by the donor. In every instance in which I have been involved, the espoused intent to "put the money back," was unsuccessful. An organization that is struggling financially and forced to "borrow" from its restricted funds is likely in trouble too deep to assume "all will be well," and a determination by its directors to take from restricted funds is unlikely to meet the standards of good faith.

6. Pay Excess compensation

My Google search for the IRS's "reasonable presumption test" for excess compensation yielded over 2,000,000 hits.[8] Excess compensation is a big deal and understandably so. Expenditure of the public's money for private benefit, as opposed to public mission, runs contrary to the very purpose of a charitable organization. But how do you know how much is too much?

At a federal level, the litmus test applied by the IRS boils down to three (3) factors (oversimplified for this presentation—§4958 I.R.C. see f.n. 8):

- The board should arrange for an "independent body" (not the person receiving the compensation) to conduct a comparability study. This could be a sub-group, such as an executive committee, or an outside consultant.
- The independent body should use *comparable* data of other organizations (similar budget size, mission, geographic region)
- Documentation is required of: who was involved in the process (to assure independence); the process itself; and evidence (such as minutes) that the full board actually considered the comparable data).

At the state level, a nonprofit corporation may pay only "reasonable" compensation for services rendered. BOC §22.054(1). There is little guidance on this standard.

Realize that the IRS's reasonable presumption test is merely that—a presumption that the compensation is reasonable. Further, state's attorneys general are not required to use the test in determining reasonableness.

[8] https://www.irs.gov/charities-non-profits/charitable-organizations/rebuttable-presumption-intermediate-sanctions; See National Council of Nonprofits https://www.councilofnonprofits.org/tools-resources/executive-compensation

7. **Make inappropriate expenditures for charitable purposes.**

This is not a typographical error. Of course, inappropriate expenses for private benefit are not authorized. Expenditures for charitable purposes can also be inappropriate. Expenditures made "ultra-vires," or outside the stated mission of the organization, are equally not appropriate. An organization organized for the specified mission of cancer research, may not expend program funds for hurricane disaster relief.[9] At the heart of the "wrong" of inappropriate expenditures lies the potential and probability for deceptive representations to the public and potential liability under the Deceptive Trade Practices-Consumer Protection Act, in addition to breach of fiduciary duty, negligence and statutory violations. Donors give based on their understanding of how the funds they donate will be used by a charitable organization. To solicit for a cause and expend for a different cause is deceptive. Further, as discussed above, expenditures of restricted funds for purposes outside the designated purpose are not appropriate without approval from a court or as otherwise authorized by law.[10] Donors, including private foundations and governmental entities, fund specific projects which meet their funding guidelines. If grant recipient is unwilling or unable to use the funds for the designated purpose, grant documents will often require reversion of the gift, or transfer to another recipient who is able to execute the intended use of the funds. In the absence of such a contemplated fix for failed purpose, a court will be required to authorize the modified use.

8. **Fail to maintain *and produce* financial records.**

Nonprofit organizations are required to maintain "current and accurate financial records with complete entries as to each financial transaction of the corporation, including income and expenditures, in accordance with generally accepted accounting principles. BOC §22.352(a). The board of directors must annually prepare or approve a financial report for the preceding year. BOC §22.352(b).

Importantly, the records must be kept at the corporation's principal office and made available to the public for inspection for 3 years.[11] Complaints to the Attorney General's Office exposing a clear violation of the statute will result in your organization receiving unnecessary notice, landing on the "radar screen," so to speak.

[9] If your organization has a "broad" purpose clause, however, such expenditures may be appropriate.

[10] §112.054 of the Texas Property Code provides standards for modifying a trust's purpose/restrictions when the purpose of the restriction has become impossible or impracticable to fulfill, and for other limited purposes. This is the codification (and expansion) of the common law, equitable doctrine of *cy pres*. With the passage of the Texas Prudent Management of Institutional Funds Act ("TUPMIFA"), (§163.001 *et seq* Tex.Prop. Code), institutional trustees, such as nonprofit corporations, that hold restricted funds will find the applicable law governing modification of restrictions to be §163.007 of TUPMIFA.

[11] *See In re Bay Area Citizens Against Lawsuit Abuse*, 982 S.W.2d 371, 380 (Tex. 1980), holding that the statute did not require the organization disclose its contributors.

It's the law. The assets you steward belong to the public and some public oversight is authorized.

9. **Be sloppy, stupid, secretive, belligerent and controlling—draw attention to your board's dysfunction.**

   When a nonprofit organization's leadership loses sight of the role that it plays in stewarding the public's funds and becomes caught up in self-preservation and "control" issues, the organization's leadership has failed. When a board member's actions are not "reasonable," board disputes inevitably develop, mistakes get made and weaknesses are exposed. People, both in and around the organization, talk. People file complaints with the Texas Attorney General, the IRS, and the appropriate criminal authorities. People go to the press! Investigative reporters love charity scandal pieces. When dysfunction on a board leads to public attention, the reputation of any nonprofit organization can be scarred and perhaps fatally so, whether legitimacy ultimately attaches to allegations or not. The best practices of accuracy, transparency and integrity are advised. They are a nonprofit board's best defense to groundless accusation.

10. **Fail to cooperate with the Attorney General.**

    No longer is this comment self-serving, in that it helps me carry out my official duties, but I make it anyway.[12] The Attorney General has the authority to inspect the management and operations of all corporations in the state, both for profit and nonprofit.[13] Further, the Texas Constitution, as interpreted by the courts and incorporated into the statutes of the state, provides the Attorney General with the duty and authority to represent the public's interest in charity. The Attorney General stands in the shoes of the stockholders in the for-profit corporation context. For a more detailed discussion of this authority, please see the accompanying article recently presented at the State Bar's Governance of Nonprofit Organizations 16th Annual Course entitled: Charitable Trust Proceedings and the Role of the Attorney General (Presented in conjunction with Governance Responsibilities Over Restricted and Endowed Funds).

C. CONCLUSION

If someone once told you that nonprofit board service was easy, she was either not aware of the duties attendant thereto, or she was not being truthful. If she told you that it was a grand public service, however, and that what was needed was someone with your strong character, good judgment and wise decision-making ability, she was already in the know. Good luck and stand strong.

[12] I no longer serve the Texas Attorney General.

[13] BOC §§12.151-156; Tex.Civ. Prac.Rem. Cd. §§17.58-61.