Board Development and Accountability

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I. Introduction

II. The Role of the Board

A. Operation of Boards. The not for profit corporation is to be managed by the Board. N-PCL §701.

1. This does not mean micro-managing the organization's day to day operations. In managing the organization's internal affairs, boards are usually involved in two key areas:

a. Oversight – i.e., of budget, fiscal controls, resource allocation, programs and key staffs.

b. Making decisions to key to the life and direction of the organization—i.e. selecting the principal executive, establishing programmatic objectives, approving long-range plans, acquiring or disposing of real property and refining the organization's mission.

c. In addition, boards are often involved in managing the corporation's external affairs - - i.e., fundraising, organizing volunteers and raising public awareness.

d. For new, developing or very small organizations, there may be a transition period when directors are much more involved in the day to day operations of the organization.

B. Serving on the board of directors of a not-for-profit corporation carries with it important responsibilities and obligations.

1. Board structure and governance are important to maintaining public trust in charitable organizations.

a. A not for profit corporation must be duly constituted and follow certain procedures in order to effectuate corporate action.

b. A not for profit corporation must show that it in fact followed proper governance procedures in order to obtain funding.

c. An organization's financial or legal problems can often be traced back to action, or inaction, of board members who either were unaware of their legal obligations or chose to ignore them.

d. By helping to ensure that directors and officers are mindful of their responsibilities, you are helping the organization protect its assets and carry out its charitable purpose.

2. This is particularly important at a time such as this when charitable organizations are being subject to heightened scrutiny.

3. Two forces influencing boards:

a. Statutory and Regulatory Provisions

b. Sector wide "best practices" being promulgated by watch-dog groups.

4. The New York Not-for-Profit Corporation Law (NPCL) sets forth the detailed rules regarding the governance of not for profit corporations operated in New York.

5. Statutory Mandates and Operation of Boards of Directors

a. N-PCL has few mandates on structure and operation of Boards.

(i) The Board of Directors of a not-for-profit corporation must have at least three members. N-PCL §702.

(ii) The Board of Directors must exercise the duty of care in making decisions and taking actions on behalf of the corporation. N-PCL §717.

b. The only qualification for board members is age - generally they must be eighteen years of age. N-PCL §701.

(i) There are exceptions for youth groups.

c. The way boards operate is guided by statute and regulation, the board's fiduciary duties and "best practices" suggested by regulatory agencies and shaped by watchdog groups and nonprofit practitioners.

C. Fiduciary Duties of the Board of Directors. See generally, N-PCL Article 7.

1. Duty of Care – requires that directors and officers be attentive to the organization's finances and activities and actively oversee the way in which assets are managed. N-PCL §717.

a. Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. N-PCL §717(a). *See* Committee to Save Adelphi v. Diamandopoulous, et al. (Board of Regents decision dated February 5, 1997); Dennis C. Vacco v. Peter Diamandopoulos, et al., 715 N.Y.S.2d 269 (1998) for analysis of failure to exercise duty of care.

b. Directors and officers can rely in good faith on "information, opinions, reports or statements" made by other officers, directors or outside experts. N-PCL §717(b).

c. Essentially, directors must use common sense, be diligent and attentive to the organization's management and attempt to make sound and informed decisions. See N-PCL §§701(a) and 717.

d. Board members have a responsibility to ensure that charitable assets are spent appropriately.

(i) Board members may be held liable for the waste or loss of charitable assets through their negligence, or for permitting improper distribution of corporate assets. The Attorney General has standing to sue directors for losses suffered by not-for-profit corporations as a result of breaches of fiduciary duties. *See* Vacco v. Aramony, N.Y.L.J., Aug. 7, 1998, p. 21 (Sup. Ct. N.Y County July 13, 1998)

(ii) Therefore, Board should regularly review organization's finances, should participate in setting compensation levels and hire competent accountants and auditors.

e. Investment of charitable assets

(i) New York State has special rules with regard to investment of organizational assets.

(ii) The Board may invest in any real or personal property it deems advisable. N-PCL §5

(iii) When making investment decisions the Board should consider the long and short term financial needs of the corporation, its cash requirements and general overall economic conditions. N-PCL § 717(a).

(iv) Investment authority can be delegated to staff members as long as the Board exercises its duty of care. N-PCL §§ 514(b) and 717.

f. Restricted assets

(i) When assets have been donated for a specific purpose they must be used for that purpose unless otherwise approved by the donor or directed by court order. N-PCL §§ 513, 522.

g. Guidelines to evidence participation and role of the board:

(i) Scheduling of regular board meetings (and maintenance of minutes and resolutions); Board members should review and approve minutes.

(ii) Establishing committees to delegate specific responsibilities

(iii) Circulation of relevant information to board (announcement of new contracts, financial information, performance reviews)

(iv) Access to corporate books and records and procedures for monitoring finances

h. Unclear whether the business judgment rule, which "bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes," applies to nonprofits. See Aurebach v. Bennett, 47 N.Y.2d 619, 629 (1979) (applying the rule to business corporations); *see also* Scheuer Family Foundation, Inc. v. 61 Associates, 179 A.D.2d 65 (1992) (not reaching

this issue because the directors breached their duty of loyalty). In a recent case the New York Court of Appeals presumed that the business judgment rule applied to a decision of not-for-profit directors. Consumers Union of U.S., Inc. v. The State of New York, 2005 N.Y. LEXIS 1433.

2. **Duty of Loyalty - Requires that board members pursue the interests and mission of the organization with undivided allegiance. See N-PCL §§ 717(a), 102(a)(5), 716 and 715.**

   a. **Essential element distinguishing a not for profit from a for profit business is the prohibition on pecuniary profit and financial gain. N-PCL §102(a)(5). Therefore, should have conflict of interest policy.**

   b. **Loans - Type B corporations are strictly prohibited from making loans to officers and directors or corporations in which one if its board members is also an officer or directors or has a financial interest. N-PCL §716.**

      (i) **Exception: One Type B to can make a loan to another Type B.**

   c. ***See* discussion of Conflicts of Interest/Excess Benefits Transactions below.**

   d. **Doctrine of diversion of corporate opportunity applies to directors of not-for-profit corporations. *See* American Baptist Churches of Metropolitan New York v. Galloway, 271 A.D.2d 92 (N.Y. App. Div. 2000).**

   e. **Concrete steps for observing Duty of Loyalty**

      (i) **Have clear procedures for setting compensation of employees.**

      (ii) **A majority of directors should have no financial relationship with the organization. Independent directors should dominate the board.**

      (iii) **Develop written conflict of interest policy that details how transaction with related parties will be considered. The policy should set forth the standards of permissible conduct. Board members should be required to comply with the policy.**

3. **Duty of Obedience - means assuring that the organization acts within the corporation's purposes and that it fulfills its mission as set forth in the certificate of incorporation. See N-PCL §§201-202, 402(a)(2).**

a. **Directors must exercise meaningful oversight to ensure that the organization complies with the law.**

b. **Case law: In re: Manhattan Eye, Ear & Throat Hospital and Memorial Sloan Kettering Cancer Center et al. v. Eliot Spitzer, 715 N.Y.S.2d 575 (1999) (the duty of obedience requires that a board of a not-for-profit corporation be faithful to the purposes and goals of the organization, which required in this case that a proposed transaction to sell or substantially all of a charity's assets promote the purposes of the charitable corporation).**

D. Liability of Board Members.

1. **Generally speaking, board members are not personally liable for the liabilities of the corporation ("corporate veil" concept).**

   a. **Section 720-a of the N-PCL provides that uncompensated directors and officers of organizations exempt under 501(c)(3) of the IRC shall not be liable for third-party suits (*i.e.*, those suits not brought by the NYS AG or the corporation itself) if the director or officer is named solely for his or her conduct in the execution of such office UNLESS**

      (i) the director or officer acted with gross negligence or

      (ii) intended to cause the harm that resulted to the person asserting liability

2. **Directors *may* be held liable for under certain circumstances:**

   a. **Breach of fiduciary obligations (duty of care, loyalty or obedience).**

   b. **Personally participating in an activity that causes injury to a third party -- *e.g.*, board member assaults patient in clinic.**

   c. **Failure to comply with certain tax or labor laws.**

      (i) There may be personal liability to the IRS for failure to pay trust fund portion of employees withholding taxes if director is deemed a "responsible person"

- **Responsible person is one who (1) was required to collect, truthfully account for and pay over employment taxes and (2) willfully failed to do so.**

- **Factors indicating whether an individual is a responsible person: they had control over funds; had authority to sign or co-sign checks; or actually signed or co-signed checks. A responsible person can be the Executive Director, other employees or members of the Board of Directors.**

(ii) Directors can be penalized by IRS for participating in "excess benefit transactions" under intermediate sanctions regulations.

(iii) Under NYS labor law there may also be personal liability for the failure to meet payroll.

E. Guidance on Fulfilling Fiduciary Duties from the NYS Attorney General: *Internal Controls and Financial Accountability for Not-for-Profit Boards* (available at http://www.oag.state.ny.us/home.html, under Charities)

1. **The NYS Attorney General recommends that all charities should have policies and procedures established so that (1) boards and officers understand their fiduciary responsibilities, (2) assets are managed properly and (3) the charitable purposes of the organization are carried out. The publication gives non-binding guidance, but the suggestions are extremely useful.**

2. **The publication suggests that nonprofits focus on at least the following areas:**

   a. **Internal controls include internal financial controls (e.g., sound accounting policies and procedures manual)**

   b. **Written job descriptions**

   c. **Personnel policies**

   d. **Training**

e. Conflicts of interest policy and code of ethics

f. Audit committee

g. Independent certified public accountants

h. Review of organization's governance structure, procedures and programs

F. Better Business Bureau "Standards for Charity Accountability"

1. In 2001, the BBB Wise Giving Alliance was formed with the merger of the National Charities Information Bureau and the Council of Better Business Bureaus Foundation and its Philanthropic Advisory Service. The BBB Wise Giving Alliance is a 501(c)(3) charitable organization, affiliated with the Council of Better Business Bureaus, which evaluates charities based on a set of twenty standards covering the manner in which charities solicit from the public, administration of assets and/or corporate governance.

2. Watchdog organizations like the "Wise Giving Alliance" have become an increasingly powerful voice in a climate of suspicion about charitable activity that has been fueled by well-publicized scandals, leading to public uncertainty about charitable accountability.

a. Failure to meet watchdog standards may substantially affect an organization's ability to attract individual donations and, in a growing number of instances, inhibit philanthropic support. Therefore, nonprofits disregard these standards at their peril.

b. Most of the standards will be applied by the BBB Wise Giving Alliance effective on March 3, 2003, but those that take longer to implement will be applied effective as late as March 3, 2005.

3. First Six Governance and Oversight Standards (can be built into Bylaws and/or corporate governance procedures). Charities Should Have…

a. A board of directors providing adequate oversight of the charity's operations and its staff.

(i) **Includes: "regularly scheduled appraisals of the CEO's performance, evidence of disbursement controls such as board approval of the budget, fund raising practices, establishment of a conflict of interest policy, and establishment of accounting procedures sufficient to safeguard charity finances."**

b. **A board of directors with a minimum of five voting members.**

(i) **The N-PCL only requires a minimum of three directors. N-PCL § 701.**

c. **A minimum of three evenly spaced meetings per year of the full governing body with a majority in attendance, with face-to-face participation.**

(i) **BBB Wise Giving Alliance provides that a conference call of the full board can substitute for one of the three meetings. For all meetings, alternative modes of participation are acceptable for those with physical disabilities.**

(ii) **N-PCL only requires one annual meeting of directors and special meetings as may be provided in the by-laws or as determined by the Board.**

d. **Not more than one or 10% (whichever is greater) directly or indirectly compensated person(s) serving as voting member(s) of the board. Compensated members shall not serve as the board's chair or treasurer.**

(i) **Reaction: Under the BBB standards, a founder may not serve as both paid staff and Board chair, contrary to practice in many start-up organizations.**

e. **No transaction(s) in which any board or staff members have <u>material</u> conflicting interests with the charity resulting from any relationship or business affiliation.**

(i) **BBB Wise Giving Alliance: Factors that will be considered when concluding whether or not a related party transaction constitutes a conflict of interest and if such a conflict is material, include, but are not**

limited to: any arm's length procedures established by the charity; the size of the transaction relative to like expenses of the charity; whether the interested party participated in the board vote on the transaction; if competitive bids were sought and whether the transaction is one-time, recurring or ongoing.

(ii) These standards are confusing. May be easier to assess such transactions based on Intermediate Sanctions regulations (discussed below) or by adopting a conflict of interest policy.

f. Have a board policy of assessing, no less than every two years, the organization's performance and effectiveness and of determining future actions required to achieve its mission. Submit to the organization's governing body, for its approval, a written report that outlines the results of the aforementioned performance and effectiveness assessment and recommendations for future actions.

(i) If this is what is called "strategic planning," every two years is too often. If annual goal-setting is intended, that would be appropriate for most organizations.

g. For additional standards on handling of finances and fundraising of the organization (there are 20 standards in total), see Standards in materials. These are equally as important a part of Board governance and include standards for:

(i) How charity spends money

- **At least 65% of total expenses should be for program activities**
- **Spend maximum of 35% of related contributions on fundraising**

(ii) Truthfulness of charity's representations

- **Make available to all, on request, complete annual financial statements prepared in accordance with GAAP.**

- **Have board approved annual budget, outlining projected expenses for major program activities, fundraising and administration.**

III. By-Laws

A. This is the instrument that sets forth how the corporation will operate and establishes the rules controlling the board's decision-making process.

B. Make sure organization has a complete and up to date copy of the bylaws.

C. Were they properly adopted either by the board, the incorporators or the membership.

D. Any amendments? Were these properly authorized and adopted in accordance with by-laws?

E. Should be referring continuously to by-laws. Does organization operate in accordance with by-laws? May not be a problem when things are good but in times of conflict can be a problem. Actions can be challenged by AG's office; 5% of members, a funder.

F. Key By-law Provisions

1. Membership vs. Nonmembership

a. Status can be designated in either bylaws or certificate of incorporation.

b. If the corporation has members qualification for membership - dues, fees, assessments must be specified in by-laws or certificate of incorporation (fact that will be levied, not exact amount). N-PCL §507(a).

c. Can have different classes, but at least one class must have full voting rights. See N-PCL §612.

d. **Must have annual meeting to elect directors. See N-PCL §603.**

e. **Should retain written minutes of membership meetings (just as you do board meetings)**

f. **Board must report annually to membership on financial condition of corporation. See N-PCL §603.**

g. **Critical that the by-laws regarding rights and power of members are observed otherwise members will have ability to challenge corporate actions. See N-PCL §623(a)(b).**

h. **Board should update the membership roster annually.**

2. **Number of directors – must have a minimum of three. N-PCL §701.**

3. **Length of director's term of office**

a. **May not exceed five years but there is no statutory limit on re-election. N-PCL §703(b).**

b. **Terms may be staggered by dividing the directors into classes, each class should contain as nearly equal a number as possible. Staggered terms allow the board to maintain institutional knowledge. N-PCL §704.**

4. **Establishing Executive and other standing committees (see below)**

5. **Removal of directors**

a. **Members and directors may remove directors for cause. N-PCL §706(a)**

b. **Members may remove directors without cause if expressly authorized by by-laws or certificate of incorporation. N-PCL §706(b).**

c. **New York State Attorney General may sue to remove directors for cause. N-PCL §§112(a)(4) and 706.**

6. ***New* Conference call participation permitted for directors, unless otherwise restricted in by-laws or certificate of incorporation. N-PCL §708(c). (Prior to recent amendment to Section 708(c), conference call participation was allowed only if expressly permitted in the by-laws or certificate).**

7. **Quorum/action requirements**

   a. **Unless otherwise indicated in the certificate of incorporation or by-laws, a majority of the board of directors constitutes a quorum for purposes of declaring the meeting convened and conducting business. N-PCL §707.**

   b. **Quorum cannot be less than: for a board of 15 or less, 1/3 of the directors or for a board of more than 15: 5 plus 1 additional member for every 10 board members (or fraction thereof) - - i.e. 7 for a board of 30. N-PCL §707.**

   c. **Unless otherwise indicated in the certificate, by-laws or statute, a board action generally requires a vote of the majority of directors present. N-PCL §708(d).**

   d. **There is no ceiling on the number of directors needed for a quorum or for voting – but a supermajority quorum requirement must be adopted by 2/3 of the voting members and, in a non-membership corporation, 2/3 of the directors. N-PCL §709.**

   e. ***New* If it's impractical or impossible for a corporation to obtain a quorum for a members' meeting, a director, officer of member can petition and obtain approval of the NYS AG and a NYS supreme court to dispense with quorum requirement. N-PCL § 608(e). The court order must provide for a method of notice reasonably designed to give actual notice to all persons entitled to notice; actual notice not necessary. The court may determine who the members are.**

G. Roster of the Board of Directors

a. Include Professional Titles, officers, and Committee Chairs.

b. TIP: Make sure that letterhead, website, etc. all list current Board members.

H. List of Standing Committees of the Board

1. Include the membership of each committee.

2. Establishing Executive and other standing committees

a. N-PCL requires authorization in by-laws or certificate of incorporation and election by majority of board in order to create a committee. Committee must consist of 3 or more directors. Authority can be set forth in by-laws, certificate of incorporation or resolution of board. See N-PCL §712(a).

b. Advantage to having an executive committee is that it can meet more regularly then the entire board or with more ease on an emergency basis.

c. Executive and other standing committees (e.g., nominating, finance, personnel, membership) may have all authorization of board, except no committee can:

(i) Submit to members any action requiring members' approval under the N-PCL.
(ii) Fill vacancies in board or board committee;
(iii) Fix compensation of directors for serving on board or committee;
(iv) Amend or repeal or adopt new by-laws; and
(v) Amend or repeal resolution of board which by its terms may not be so amendable or repealable. N-PCL §712(a).

I. Minutes

1. **Requested: approved minutes from the most recent meeting of the Board**

2. **Minutes of board meetings and committee meetings must be maintained.**

   a. **Minutes should reflect decisions made and actions taken or to be taken by the board (e.g., adoption of an employee handbook, entry by the corporation into a material contract, resolution regarding authorization of expenditures, ratification of actions taken by officer, directors or employees since last Board meeting).**

   b. **Do not be overly detailed – can be difficult balance: too much detail can be harmful and too little detail fails to lay the required paper trail (e.g., Intermediate Sanctions and excess benefit transactions).**

IV. Additional Policies and Procedures

A. Conflict of Interest Policy

1. **Need policy to help determine what constitutes an "interested parties transaction" and how the reasonableness of those transactions will be measured. Directors should sign annual statement of compliance with policy, including disclosure of any possible conflicts.**

2. **Conflicts of Interest: State Law Considerations**

   a. **There are circumstances under which a not for profit corporation can cancel or void a transaction -- where a director or officer has a financial interest or serves on the boards of both parties to a transaction. N-PCL §715. In order for such a transaction to be binding on the corporation:**

(i) The material facts of the director's or officer's interest in the transaction must be disclosed in good faith to the board members or known by them; and

(ii) The transaction must be authorized by a board vote sufficient for those purposes without including the vote of the interested directors. N-PCL §715(a)(1).

(iii) While the vote of the interested director cannot be counted, the interested individuals can be counted when determining whether a quorum is present. N-PCL §715.

(iv) Alternatively, in a membership corporation, if the material facts are disclosed to the members, the transaction can be approved by the membership. N-PCL §715(a)(2).

(v) If the board approves the transaction without the proper disclosure, the transaction will still be binding if it can be established "affirmatively that the contract or transaction was fair and reasonable as to the corporation . . ." N-PCL §715(b).

3. Conflicts of Interest: Internal Revenue Code

a. IRC §501(c)(3) provides that, for organizations exempt from taxation under that section, "no part of [its] earnings . . . [shall] inure to the benefit of any private shareholder or individual."

b. These regulations provide the IRS with a remedy to control undue personal inurement, one that is less drastic than revocation of exempt status, and introduce for the first time taxes on self-dealing involving the assets of public charities. Regulations impose penalty taxes on "disqualified persons" in the event of an "excess benefit transaction."

c. Intermediate sanction rules apply to all 501(c)(3) and 501(c)(4) exempt organizations, including 501(c)(3) organizations not required to seek recognition of exempt status (e.g., churches and those with less than $5000 gross receipts).

d. **The statute and the regulations do not contain any explicit deference to state-law standards for fiduciary conduct (in a "no preemption" provision). The enforcement of the new rules for such conduct -- in the scope of who is covered, what conduct is implicated, and, especially, in the "safe harbor" provisions providing protection from liability -- may affect the interpretation of state statutes that regulate the same conduct.**

e. **Excess Benefit Defined - is any transaction in which an economic benefit is provided by a tax-exempt organization to a disqualified person if the value of the benefit exceeds the value of the consideration.**

(i). **Reasonable compensation is not excess benefit.**

(ii). **Reasonable compensation is what would ordinarily be paid for like-services under similar circumstances.**

f. **The portion of the transaction subject to the Intermediate Sanction is the difference between the value of the consideration paid to the disqualified person and the value of the consideration received in exchange by the tax-exempt organization.**

B. Financial Controls Policy or Procedure

1. **Requested: policies governing financial transactions; writing and depositing checks; administering corporate credit cards; and handling petty cash.**

2. **Failure to maintain procedures for these common transactions leaves the organization vulnerable to, at a minimum, unnecessary financial losses and, at worst, embezzlement by dishonest employees.**

3. **Failure to have written policies in place will be of concern to potential donors, as well as to regulatory bodies.**

C. Policy Re: Hiring/Compensation of Key Employees Family Members

1. **Although nepotism is not illegal – it is a breach of many city contracts. Rules prohibiting an employee from reporting to a close family relative promote objective management and reduce the perception - or reality - of favoritism.**

2. **Furthermore, while MOCS has not defined "key employee," family members of key employees may meet the definition of "disqualified person" for purposes of determining whether there has been an excess benefit transaction.**

D. Employee Loan Policy.

1. **Loans to employees are not illegal, but loans may be used as a vehicle for private inurement by dishonest employees. Therefore, an organization may choose to have a policy prohibiting loans to employees, or it may have a policy which regulates the employees may receive loans, the size of the loans and under what circumstances.**

2. **Loans to disqualified persons may be an excess benefit transaction.**

3. **Loans to directors and officers of a nonprofit organization are prohibited by New York law. N-PCL § 716.**

E. Whistleblower Policy

1. **The Sarbanes Oxley Act of 2002, enacted in response to corporate scandals such as Enron and Worldcom, generally applies only to publically traded companies. However, two provisions, prohibiting (1) destruction of records to obstruct a government investigation and (2) retaliation against whistleblowers, apply to nonprofits as well. The whistleblower provision provides:**

It is a crime to knowingly retaliate, including by interfering with their lawful employment or livelihood, against any person for providing truthful

information to a law enforcement officer relating to the commission or possible commission of a Federal offense. Punishable by fine and/or up to 10 years imprisonment. Sarbanes-Oxley Act of 2002, 107 P.L. 204, Title XI, Section 1107.

2. **Sarbanes Oxley protects employees from retaliation for reporting violation of laws that constitute a Federal offense. It does not require adoption of whistleblower policy but nonprofit governance types and auditors are recommending that nonprofits adopt such policies.**

3. **In addition, health care entities that receive or make more than $5 million in Medicaid payments must notify their employees of state and federal laws protecting whistleblowers.**

V. Board Operations

A. Meetings

1. **How often has the Board met in the last year? The only legal requirement is that the Board meet once a year; BBB recommends three meetings; Lawyers Alliance recommends that the Board meets quarterly.**

B. Distribution of Minutes

1. **Minutes evidence the decision-making processes of the board.**

2. **The law assumes, rather than requires, that minutes will be kept. There is no legal requirement that minutes be distributed prior to each Board meeting, but best practice is to review minutes at the start of a meeting, make necessary corrections and approve the minutes.**

3. **Minutes should be maintained by the corporation along with a record of resolutions.**

4. **Dissemination of Information**

a. Organizations must be prepared to explain how new board members receive orientation or training in their role as "stewards" of the organization, as well as how key staff members learn policies and procedures.

b.MOCS contemplates that handbooks, manuals, or, at a minimum, written policies, are available.

c. Attorney General has Right from the Start on its website outlining duties and responsibilities.

5. Financial Oversight

a. Financial oversight is an important part of the Board's fiduciary duty of care.

b. Board should review and approve budget annually. In addition, the board should be reviewing quarterly financials and cash flow projections.

c. It is possible to delegate some of these responsibilities to an executive or finance committee but those committees should be reporting back to the entire board regularly.

d. A staff member should have responsibility for preparing financial statements on a regular basis for the Board's review. A senior staff member or financial officer should present the financial statement at Board meetings.

e. Recently, watchdog groups and government regulators (see Independent Sector report) have emphasized the need for greater financial expertise by nonprofits.

6. Loans to Key Employees

a. As discussed above, loans are not illegal, but loans to key employees may have legal and tax consequences.

7. Employees on Board

a. There is no per se legal prohibition on paid staff serving on the organization's board of directors.

b. Paid staff, however, will be considered to be an "interested person" and thus have a conflict when voting on any matter relating to their compensation or performance. Therefore, must adhere to the conflicts of interest policy.

c. BBB recommends not more than one or 10% (whichever is greater) directly or indirectly compensated person(s) serving as voting member(s) of the board. Compensated members shall not serve as the board's chair or treasurer.

8. Financial Controls

a. The board or its finance or audit committees should closely analyse the organization's internal controls to ensure that the proper safeguards are in place.

b. Need to ensure that charitable funds are used for the purposes for which they were raised.

9. Payroll

a. While not legally required, an automated payroll system reduces the chances of payroll errors, which could result in legal liability.

b. **Also reduces board member risk related to failure to remit trust fund portion of payroll taxes.**

VI. Executive Compensation

A. Performance Review of Chief Staff Person

1. **Because there is a legal requirement that executive compensation be "reasonable," a written performance evaluation can help to establish reasonableness.**

2. **Although there is no legal requirement to do so, the Board should review the entire compensation package annually.**

B. Review of Chief Staff Person's Expenses

1. **Reimbursement of expenses is potentially another form of compensation and should be reviewed for reasonableness.**

2. **Personal expenses of staff members should not be paid with charitable funds.**

3. **Consider reasonableness of housing and car allowances in light of overall compensation packages.**

4. **Have procedure for expenses of chief executive reviewed (at least periodically) by someone other then a subordinate.**

C. Executive Compensation must be considered as a potential excess benefit transaction.

1. **A disqualified person is any person during the five-year "look back period" who exercised substantial influence.**

2. **A person will be considered to hold substantial influence when they are:**

a. A voting member of the board of directors;

b. A person who has ultimate authority for implementing decisions of the board or is responsible for supervising management, administration or operation of the organization; or

c. A person who has ultimate responsibility for managing the finances of the organization.

3. Additionally, founders of the corporation and significant contributors may be viewed as having substantial influence.

4. A person will be considered a disqualified person if they are a family member of a person in a position to exert substantial influence. Entities in which persons with substantial influence over the organization (or their family members) hold more than 35% of the voting power, profits interests or beneficial interest will also be considered disqualified persons.

5. Certain people are presumed not to be in a position to exert substantial influence:

a. An exempt organization under sections 501(c)(3) or (c)(4), except private foundations; and

b. An employee receiving less than $100,000 in annual compensation who is not a person with ultimate authority for management or financial decisions, substantial contributor or a disqualified person for other reasons.

6. Whether or not a person is considered a disqualified person will depend upon the facts and circumstances of each individual case.

D. Penalties

1. **Disqualified persons**

   a. **Initial penalty of 25% on excess benefit amount.**

   b. **If not corrected (i.e. repayment to organization) 200% tax can be imposed.**

   c. **Organization managers**

   d. **10% tax is imposed personally on each organization manager who knowingly participated in excess benefit transaction.**

   e. **Subject to $10,000 cap currently; for tax years beginning in 2007, cap is $20,000.**

   f. **If more than one manager is liable; joint and several liability.**

E. Rebuttable Presumption

1. **The parties to a transaction can rely upon a rebuttable presumption that a transaction with a disqualified person is reasonable when:**

   a. **The transaction is approved in advance by the board of directors;**

   b. **The board was comprised entirely of disinterested persons;**

   c. **The board obtained and relied upon appropriate comparable data; and**

   d. **Adequately documented its reasons for its decisions.**

2. **For purposes of the rebuttable presumption it is not enough for board members to disclose a conflict, rather the board approving the transaction must be entirely free of any conflict of interest.**

3. **When considering the comparability of compensation the relevant data which the board can consider includes, but is not limited to:**

    a. **Compensation levels paid by similarly situated organizations, both exempt and non-exempt;**

    b. **The availability of similar services within the geographic area;**

    c. **Current compensation surveys compiled by independent firms;**

    d. **The survey need not be independently commissioned.**

    e. **Written offers from institutions competing for the same person's services.**

F. Small Organizations

1. **For organizations with gross annual receipts of less than $1 million reviewing compensation arrangements will be considered to have appropriate comparable data if it has data on compensation paid by 3 comparable organizations in the same geographic area for the same services.**
2. **An organization may calculate its annual gross receipts based upon an average of its gross receipts during the three prior tax years.**

    a. **When a tax-exempt organization controls or is controlled by another entity, the gross receipts must be considered in the aggregate to determine if the small organization rule applies.**

G. Documentation

1. **For a decision to be adequately documented the minutes of the board meeting at which the transaction is approved must include:**

a. The terms of the transaction as approved and the date upon which it is approved;

b. A list of the board members who were present and voted;

c. The comparability data upon which they relied and how it was obtained; and

d. Any actions taken by board members determined to have a conflict of interest.

2. The decision must be documented concurrently with approval of the transaction.

a. The record must be prepared before the later of the next meeting of the board of directors or 60 days after the final action.

3. See model conflict of interest policy that the IRS attaches to Form 1023, application for tax exemption.

H. Organizational Managers

1. An organization manager can be deemed to have participated in an excess benefit transaction through silence or inaction when the manager is under a duty to speak or act and fails to do so.

2. An organizational manager must actually oppose the transaction in a manner consistent with its fiduciary responsibilities.

a. Must exercise ordinary business care and prudence in reviewing these transactions.

3. An organizational manager will not be considered to have acted knowingly, even though a transaction is later deemed to be an excess benefits transaction, if after full disclosure of the factual situation to an appropriate professional, the manager relies upon the written opinion of the professional that the transaction does not constitute an excess benefit to a disqualified person.

a. **The professional upon whom the organizational manager is relying must be either:**

(i) **Legal counsel, including in-house counsel;**
(ii) **Certified public accountants or accounting firms with expertise regarding the relevant tax law matters; or**
(iii) **Independent valuations experts.**

4. **An organizational manager who relies upon the rebuttable presumption will not be considered to have acted knowingly if it is subsequently determined that the benefit paid was an excess benefit.**

VII. Financial Transparency

A. **Form 990 is an annual report that must be timely and accurately filed with the IRS. Designed to give the IRS and public information regarding charitable organizations operations.**

1. **Annual information returns to the IRS on Form 990 or 990EZ AND beginning in 2007, for organizations receiving less than $25K annually, an annual notification to the IRS.**

2. **Annual report on Form 990-T for orgs with unrelated business taxable income.**

B. **Public may rely on information contained in Form 990, e.g., foundations and donors (and therefore may also be thought of as a "marketing" tool). IRS requires that the 990 be made "generally available" either by posting it on the web or by making it available at your headquarters.**

C. **May satisfy certain state filing requirements.**

D. On December 20, 2007, the IRS published the new Form 990. The revised Form 990 reflects the increasing complexity of the nonprofit sector and requires increased reporting of governance practices.

1. **The current Form 990 will be used for the 2007 tax year, which is filed during 2008. The revised Form 990 will be used for the 2008 tax year (filed in 2009); however, to ease the burden on smaller organizations, the IRS temporarily has established an adoption timeline that will allow some organizations to file the Form 990-EZ:**

Eligible for 990-EZ in:	**If your annual gross receipts and assets are:**
2008 tax year (filed in 2009)	**Annual revenues are between $25,000 and $1 million and net assets are less than $2.5 million**
2009 tax year (filed in 2010)	**Annual revenues are between $25,000 and $500,000 and net assets are less than $1.25 million**
2010 tax year (filed in 2011)	**Annual revenues are between $50,000 and $200,000 and net assets are less than $500,000**

2. **How is $25,000 gross receipts calculated? An organization's gross receipts are considered normally to be $25,000 or less if: the organization is up to one year old and has received or donors have pledged to give $37,500 or less during its first tax year; between 1 and 3 years old and averaged $30,000 or less in gross receipts during its first 2 tax years; or 3 or more years old and averaged $25,000 or less in gross receipts for the immediately preceding 3 tax years (including the year for which the return would be filed).**

E. New Form 990

1. **Consists of an 11-page "core" plus 14 schedules.**

2. **Every organization filing a Form 990 must complete the core form, but the specific schedules required depends on the organization's activities. You should also consult with an accountant to review the financial reporting issues raised by the revised Form 990.**

3. **Summary page includes overview of the organization's activities and governance, revenue, expenses, and net assets.**

   a. **Requires organization to list the number of employees earning $100,000 or greater and the highest amount of compensation paid to any individual.**

4. **Part VI includes the governance, management, and disclosure questions.**

   a. **How many independent members of your governing body do you have?**

      i. **Independent members are generally those not receiving direct or indirect compensation from the organization.**
      ii. **Disclosure is required of relationships (both family and business) between officers, directors, trustees or key employees another then their involvement in the organization**

   b. **Have you delegated managerial duties to a management company or other person?**

   c. **Do you have a conflict of interest policy? If so, does your policy require annual disclosure by officers, directors, trustees and key employees? How do you monitor enforcement of your policy?**

   d. **Do you have a document retention policy, destruction policy, and whistleblower policy?**

   e. **Does your process for determining compensation of your CEO or executive director and other key employees include a review and approval by independent persons, comparability data, and evidence of deliberation and decision?**

f. Have you invested or participated in a joint venture? If so, have you adopted a written policy with respect to joint ventures?

g. Are the organization's governing documents, conflict of interest policy, and financial statements available to the public?

5. Part VII includes disclosure of compensation information. In addition to listing each officer, director or trustee and indicating whether they are compensated, you must list compensation information for the following individuals:

a. Five highest compensated employees;

b. Former officers or employees who received more than $100,000; and

c. Former directors or trustees who received more than $10,000.

6. Additional governance information will be disclosed on Schedule L:

a. Part I requires information on excess benefit transactions;

b. Part II requires disclosure of loans made to current or former employees or other interested people;

c. Part III asks about grants or other assistance to employees or interested people; and

d. Part IV requires disclosure of business relationships (direct or indirect) and family relationships between the organization and its officers, directors, trustees and key employees.

7. The revised Form 990 is available at: http://www.irs.gov/charities/article/0,,id=176637,00.html. Instructions for the revised Form 990 were released on April 7, 2008.

F. Penalties

1. **Pursuant to the Pension Protection Act, failure to file the Form 990 or 990-EZ for three consecutive years will result in revocation of exempt status, effective the filing due date for the form in the third year.**

2. **Failure to file Form 990 can result in additional severe penalties.**

   a. **A penalty of $20 a day, not to exceed the smaller of $10,000 or 5% of gross receipts of the charity for the year, may be imposed against the charity when a return is filed late or contains inaccurate or incomplete information, unless the charity can show that the late filing was due to reasonable cause.**

   b. **Charities with gross receipts exceeding $1 million are subject to a penalty of $100 per day up to a maximum of $50,000.**

3 **Potential personal liability - if charity fails to file a Form 990, or files an incomplete or incorrect Form 990, the IRS will send a letter fixing a date by which the charity must satisfy these requirements.**

   a. **If the charity fails to meet this deadline, the RESPONSIBLE PERSON may be held personally liable by the IRS for a penalty of $10 a day, not to exceed $5,000.**

4. **If charity is required to file a Form 990 and has failed to do so, file the Form 990 as soon as possible.**

5. **What if penalties are imposed?**

   a. **The IRS can reduce penalties imposed for failure to file Form 990 if the charity can demonstrate reasonable cause for the failure. Examples of reasonable cause include: reliance on advice of attorney or tax professional that was incorrect; death of responsible person; or inability to obtain necessary documents.**

   b. **If charity receives a tax notice from the IRS stating that penalties are owed for failure to file Form 990 it's a good idea to contact legal counsel.**

G. Registration with the Charities Bureau of the NYS AG and filing Annual Report on Form 500.

1. **Form CHAR410 Charitable Registration Statement**
   a. **With certain exemptions, charitable organizations must register with the Attorney General before soliciting. Exec. Law § 172.**

   b. **Exempted entities include - organization that does not intend to, and does not, receive $25,000 during the organization's fiscal year, provided that none of its fundraising activities are carried out by professional fundraisers or fundraising counsel. Exec. Law § 172-a(2)(d).**

   c. **With certain exemptions (similar to but not congruent with Executive Law Article 7-A) "trustees" administering finds for charitable purposes must register (one time) and file annual financial reports with the Attorney General. Estates Powers and Trusts Law § 8-1.4.**

   d. **End result: most nonprofits in NYS must register. Register on Form CHAR410 – submit a registration statement, organizational and other documents, and a $25 registration fee. Exec. Law § 172.1**

   e. **Dual registrants: Charities subject to registration pursuant to both Article 7-A and the EPTL are "dual registrants" and must register pursuant to both statutes.**

2. **All charities registered with the NYS Attorney General's Office must file annually on Form CHAR500**

   a. **Can attach Form 990 or 990-EZ, as required, to the form.**

   b. **Depending on amount of assets and revenue, may have to submit independent accountant's review or audit report**

H. Lobbying Reporting and Registration.

1. **Organizations exempt under 501(c)(3) of the Internal Revenue Code can only engage in an insubstantial amount of lobbying and cannot engage in any political activity. See Internal Revenue Code §170(c)(2), 2522(a)(2).**

   a. **Boards should be sure that lobbying limits are not exceeded by organization and that it does not engage in any partisan political activity.**

   b. **If a charity exceeds the limitation on lobbying activity or violates the prohibition on political activity, the IRS can revoke its tax-exempt status and/or impose a tax on the impermissible expenditures.**

2. **Organizations must report on Schedule C to 2008 Form 990 (Schedule A, Part VI of the 2007 form) any expenditures for lobbying activity incurred during fiscal year.**

3. **Nonprofit organizations must register as lobbyists with the Secretary of the Senate and Clerk of House of Representatives if**

   a. **The lobbying individual has made at least two legislative contacts (with federal legislators or certain members of Federal Executive Branch) and has spent at least 20% of his or her time on lobbying activity; and**

   b. **The organization employing the lobbying individual spent at least $24,500 on lobbying during that semi-annual period.**

4. **Nonprofit organizations must register as lobbyists with New York Commission on Public Integrity and/or with New York City Clerk's Office if they lobby and expend more than $5,000 in a calendar year on lobbying with respect to the NYS Commission and $2,000 for the NYC Clerk's Office.**

   a. **Includes lobbying before state and local (but not Federal) legislative bodies or administrative agencies on administrative rulemaking only.**

b. No limit on lobbying, but imposes cumbersome reporting annual and periodic filings.

c. The NYS Lobbying Act and NYC Lobbying Acts were amended very recently and have been amended in the past several years.

5. New Developments re: Member Items & Discretionary Funds

a. Certifications Required. NYS Legislature has revamped its procedures for receiving member items. Organizations that receive member items will be asked to provide certifications to the agency with whom they contract for the funds.

b. Nonprofits may consider whether to adopt annual disclosure statements from board members and senior staff to capture the information required by the certification.

c. Nonprofits should ensure their annual financial filings with the Attorney General and IRS are up to date.

d. Nonprofits should consider developing internal procedures to track the information required by the certification.

6. Requests for Discretionary Funds and Member Items are considered Lobbying.

a. NYS Legislature now votes on member items as a line item in the budget, which means that communications and requests for member items from state legislators are lobbying.

b. NYC's Clerk's Office views all communications with city legislators for discretionary funds to be lobbying communications.