Nonprofit Corporation

Members:
- Voting
- Non-voting
- Hybrid of voting and non-voting
- Board

Directors:
- Minimum of 3 in most states
- Keep it odd – no tie votes!
- Act as a unit to make all organizational decisions, then Officers or employees/independent contractors carry out the Board’s decisions

Officers:
- President
- Treasurer
- Secretary
- Others

Hired Staff/Officers

Volunteer Officers

Directors

Members

Public
Function of the Board

The critical function of a Board is to govern the nonprofit organization – to manage its overall business and affairs.

It is ordinarily not the function of the Board Members to manage the day-to-day activities of the organization or to act in the role of an Executive Director. Rather, Board Members should appoint Officers, hire staff and/or secure volunteers, as well as assign responsibilities to these individuals so that the Officers, staff, and volunteers can effectively carry out the daily tasks of running the nonprofit.

It also means that Board Members must supervise and direct the Officers, staff, and/or volunteers and govern the organization’s efforts in carrying out its mission.
Function of the Board

The Board of Directors should be fulfilling the following functions:

• Hold Annual and Regular Board Meetings
• Elect/appoint Officers (assuming this function lies with the Board and not a voting membership)
• Elect Board Members (assuming this function lies with the Board and not a voting membership)
• Approve Prior Actions of Officers (if necessary and proper)
• Approve Prior Actions of Board Members (if necessary and proper)
• Revise/maintain/implement the Articles of Incorporation and Bylaws, as well as all other policies and procedures
• Approve Proactive Compliance Measures and Necessary Reviews
• Approve Actions by Authorized Agents (Accountant, Attorney, Other Advisors, etc.)
• Approve Financial Statements, including: Budget, P&L, Balance Sheet, & Others
• Approve Major Agreements (Contracts, Purchase/Lease Agreements, Loans, etc.)
• Approve Major Purchases (Equipment, Building(s), Vehicles, Technology, Furniture, etc.)
• Approve General Business Actions (Audits, Tax Forms and other Governmental Filings, Insurance, Investments, etc.)
• Approve Employee Matters (Additions, Terminations, Benefits Changes, Handbooks, Classifications, etc.)
• Approve Compensation Paid (Employee Wages/Salaries, etc.)
• Hire/fire employees and Contractors (unless this function lies with the Executive Director)
• Assure the organization is financially viable and sustainable
ACT AS A BOARD

The Board as a whole, not any of the individual Board Members of Officers, is the decision-maker and authorizer.

If the Board does not vote, the organization has not approved the action.

If a Director or Officer acts without Board approval, he/she may become personally liable for that action.
Directors’/Officers’ Liability in Minnesota

Minn. Stat. § 317A.257, Unpaid Non-profit Directors and Officers

The following people are not *civilly* liable for an act or omission if it was in good faith and within the scope of their official responsibilities:

– a person who serves without compensation as a director, officer, trustee, agent or member of a non-profit organization,

– a person who serves without compensation as a fire chief of a non-profit fire fighting corporation or a municipal volunteer fire department.

*Exceptions:* 1.) An act or omission that constituted willful or reckless misconduct. 2.) An action or proceeding brought by the attorney general for a breach of a fiduciary duty as a director. 3.) A cause of action to the extent it is based on federal law. 4.) A cause of action based on the person’s express contractual obligation.
Limited Liability

Nonprofit corporations generally provide limited liability for their Directors, Officers, Trustees, Members, employees, volunteers, etc.:

• Nonprofit corporations are independent entities with their own legal liability. This is to say nonprofit corporations have a separate legal existence apart from their Directors, Officers, Trustees, Members, employees, volunteers, etc.

• Directors, Officers, Trustees, Members, employees, and volunteers serving a nonprofit corporation WITHOUT COMPENSATION will have limited liability, and generally not be personally liable for the debts and obligations of the nonprofit corporation.

• Exceptions to limited liability, generally: If the Director, Officer, Trustee, Member, employee, and/or volunteer
  – is paid for his/her service (i.e., paid CEO, CFO, ED)
  – breaches his/her fiduciary duties while executing his/her official responsibilities
  – is sued by the Attorney General or Secretary of State for breach of fiduciary duty
  – is sued under federal law
  – is sued based on the person’s express contractual obligation (i.e., he/she signs a contract without Board approval)
  – is NOT sued based on his/her activities as a Director or Officer (outside the scope)
Directors’/Officers’ Liability in Minnesota

Semi-Recent Case Law

Rehn v. Fischley, 557 N.W. 2d 328, 1997 – An unpaid director at the Humane Society directed the use of a chemical to clean cages that caused injury to a worker. The court found that § 317A.257, immunity for a non-profit volunteer is a statutory defense, and cannot be waived by failing to mention it in responsive pleadings.

Immunity is provided by the statute to those who, by their status as uncompensated persons, qualify for its protection from facing suit. The broad wording protects all uncompensated persons acting on behalf of the non-profit, not just those acting within the specific scope of their job description. Thus, a director acting outside the scope of his duty as a board member, as the director in this case did, is protected from liability as he was acting on behalf of the non-profit.
Fiduciary Duties

Being a Board Member is more than an honor – Directors, Trustees, and Officers have fiduciary obligations to ensure that the mission of the organization is honored and that resources of the group are used wisely in support of that purpose. Minnesota recognizes 3 Fiduciary Duties:

– Duty of Care
– Duty of Loyalty
– Duty of Obedience

Failure to follow through on the legal duties of Board Membership can have devastating consequences for a charitable organization. There may also be civil or criminal penalties levied against Board Members who shirk their responsibilities, particularly in situations in which they have benefitted from their action or inaction.
Fiduciary Duties

**Duty of Care:** Board Members have a responsibility to be active in the nonprofit corporation’s affairs.

- Board Members of a nonprofit corporation must discharge their duties in good faith, in a manner the Board Member reasonably believes to be in the best interests of the organization, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances;
- Prepare for Board Meetings by reading and reviewing reports, minutes, and other materials distributed for the meeting;
- Attend Board and Committee Meetings and take note of all actions taken or decisions made;
- Ask questions and obtain the information necessary to make informed decisions. Exercise independent judgment rather than blindly following other Board Members or the staff’s requests;
- Review the performance and compensation of the Executive Director and/or Chief Executive Officer, and ensure that the nonprofit corporation’s purposes are fulfilled efficiently and follow sound business standards.
Avoiding Theft in Your Nonprofit

Some Ideas:
• Require dual signatures
• Reconcile bank statements
• Limit use of cash
• Establish check-handling procedures
• Work from vendor lists
• Develop payroll controls
• Establish expense reimbursement policies
• Match physical and recorded inventories
• Set and follow budgets
• Employ competitive bidding
• Monitor grant administration
• Consider background and credit checks (may be required with certain missions)
• Require vacations and rotation of duties
• Change passwords, combinations, and locks
• Establish whistleblower policies
• Consider insurance coverage
• Assess internal controls
• Have an audit committee and recruit new members on a regular basis
• Know the warning signs – complaints, missing $, late/non-existent financials, unpaid invoices, significant changes in revenue/expenses compared to previous years, unexplained changes in employee/volunteer lifestyle
• Develop a fraud action plan
Duty of Care Traps

Watch the money....

- Be sure loans are approved by the Board and they aren’t inadvertent donations.
- Try not to use debit cards – they encourage misspending and circumvent internal controls.
- Don’t use personal funds for the nonprofit’s expenses – it throws off the nonprofit’s books and denies the individual the charitable deduction. Make a donation and to the charity and let the charity buy it’s own goods/services.
Duty of Loyalty: Requires that the interest of the charity and its objectives take precedence over a Board Member’s personal interests or those of family or friends

- Board Members have an absolute duty of complete, undivided loyalty to the organization. This means that Board Members should avoid using their position, or the organization’s assets, in a way that would result in a pecuniary or monetary gain for themselves or for any member of their family. A Board Member should put the good of the organization first and avoid engaging in transactions with the organization from which he/she would benefit;

- The charity should establish a written policy for dealing with conflict-of-interest situations;

- Any conflicts of interest between the organization and a Board Member should be resolved in favor of the organization unless the conflict of interest is waived by the Board as a whole (with the conflicted Board Member abstaining from the vote);

- The charity should not engage in any transaction that hurts the organization or in any activities that compete with the interests of the charity or result in any personal advantages based on the charity’s business dealings;

- See, also, Minn. Stat. § 317A.255. Director Conflicts of Interest.
Fiduciary Duties

Duty of Obedience: Board Members have a responsibility to be faithful to the organization’s purpose and mission. They must also adhere to the organization’s governing documents and to laws and regulations that related to the charity and its operations

- Board Members must understand and follow the charity’s governing documents (Articles of Incorporation, Bylaws, Constitution, Codes of Conduct, Codes of Ethics, Policies & Procedures, etc.)
- Board Members must be familiar with state and federal laws related to nonprofit entities, fundraising, and tax-related issues as well as legal issues connected with the organization’s charitable purpose and operations. For example: Minn. Stat. Chapters 309, 317A, 501B and other mission-specific statutes, as well as Internal Revenue Code Chapters 509(a) and 501(c).
- The nonprofit corporation must comply with state and federal registration and reporting requirements, including annual filings with the Attorney General’s Office, the Secretary of State, the IRS, and other governmental entities.
- Board Members must ensure that charity funds are used for lawful purposes. This includes the organization’s mission, a reasonable amount of administrative expenses, and not the private inurement of Board Members.
- See, also: http://www.ag.state.mn.us/Charities/FiduciaryDuties.asp
Avoid these compliance follies….

– Renew with the MN Sec. of State every year by 12/31.
– File the Form 990 ON TIME or with an extension every year. $20/day if late.
– Register with the MN Attorney General under charitable solicitation if the charity raises, or intends to raise, $25,000 in MN. If it doesn’t, but the charity has $25,000 in assets, it still needs to register under charitable trust. Tips:
  • If the charity requests a formal exemption under charitable solicitation, but is a 501(c)(3), it may still need to register under charitable trust.
  • If the charity solicits in states other than MN, it may need register with those states and may need an audit.
– Watch out for inadvertent professional fundraising. Professional fundraisers need to be registered with the MN Attorney General BEFORE fundraising, and bonded if they are going to have any control over charitable dollars.
TAKEAWAY: Directors’/Officers’ Liability in Minnesota

The Keys to Preserving Limited Liability of Officers & Directors are:

- NO COMPENSATION
  - It’s a conflict of interest
  - Funders don’t like it
  - It kills limited liability under 317A.257
  - Remember what qualifies as "compensation"

- Abiding by fiduciary duties
- Acting WITH Board authority
- Acting within the scope
Indemnification

- **What is it?** "To protect (someone) by promising to pay for the cost of possible future damage, loss, or injury."

- **How it works**: Nonprofit corporation and individual Officers/Directors are sued. Individual Officers/Directors seek indemnification from nonprofit corporation.

- See Minn. Stat. § 317A.521

- **Get D&O Insurance!** – Otherwise indemnification is only as good as the nonprofit’s bank account

- Officer/Director seeking indemnification must make a formal request of the Board of Directors, and the Board can determine whether the Officer/Director is eligible per Minn. Stat. § 317A.521, Subd. 2 & 6. See also, *Asian Women of Minn. v. Leiendecker*, 789 N.W.2d 688 (Minn. App., 2010).
IRS Considerations

Recall that “a cause of action to the extent it is based on federal law” defeats limited liability under Minn. Stat. § 317A.257:

• To obtain and keep its federal tax exemption as a charitable organization, an organization needs to broadly benefit the public and not the individual Officers/Directors.

• Penalties include revocation of 501(c)(3) status and/or intermediate sanctions.
IRS Considerations

Terms: **Private Inurement** – Regs. 1.501(c)(3)-1(c)(2) explains the prohibition against private inurement as follows:

- Private inurement relates to a distribution of earnings problem. An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private individuals (“disqualified persons” or “insiders”) such as a Director, Officer, or other person having a personal and private interest in the activities of the organization. For the definition of the words "private shareholder or individual," see paragraph (c) of section 1.501(a)-1.

- A 501(c)(3) organization that violates the private inurement doctrine fails to be operated exclusively for one or more exempt purposes and is subject to revocation of its exempt status. (See Treas. Reg. Section 1.501(c)(3)-1(c)(2)).

  - It is important for public charities to understand the private inurement doctrine does not bar the organization from entering into transactions with insiders. The private inurement doctrine does however bar the organization from providing a disproportionate share of benefits to an insider regardless of whether the inurement conferred is $1 or $1,000.
  - Private inurement violations may be found in situations involving:
    - A compensation arrangement with an insider where there is no upper limit (see People of God Community);
    - A compensation arrangement that is based on factors extrinsic to performance at and benefit to the organization (see G.C.M. 39498) – i.e., compensation arrangements with added considerations such as deferred compensation, bonuses, fringe benefits, or retirement or severance packages;
    - Use of gross or net earnings to provide goods and services to insiders; or
    - Paying more than fair market value in exchange for goods or services provided by an insider.
    - Assignment of rights to intellectual property developed by insiders and funded, in whole or in part, with organizational assets;
    - Use of organizational assets to support, fund, or otherwise invest in an insider’s business.
IRS Considerations

Terms: **Private Benefit**:

- Charities are required to serve the public at large rather than a small group of individuals or a narrow class of intended beneficiaries. In *Alive Fellowship of Harmonious Living*, T.C. Memo. 1984-87, stated that the requirement that an exempt organization be operated for public rather than private benefit is but another way of requiring that it be operated exclusively for exempt purposes; it is a factual issue. Although the requirements for finding inurement or private benefit are similar, inurement and private benefit differ in that inurement has generally been applied only to insiders with some authority with respect to an organization, whereas private benefit may accrue to an independent outsider. Moreover, even a minimal amount of inurement can result in disqualification for exempt status, whereas private benefit must be substantial in order to jeopardize exempt status. However, even substantial private benefit may be tolerated where it is incidental to the accomplishment of charitable purposes.

- Regs. 1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. The regulation places the burden of proof on the organization to demonstrate that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, or persons controlled directly or indirectly by such private interests.

- For more info:
IRSI Considerations

Terms: **Excess Benefit Transactions**:

- Codified in section 4958 of the Internal Revenue Code ("IRC").
- The excess benefit transaction rules apply to any entity that has status as a 501(c)(3) public charity or 501(c)(4) organization (i.e., social welfare organizations) at any time during a **five-year look back period** from the date the excess benefit transaction occurred:
  - An **excess benefit transaction** is defined as any transaction in which an economic benefit is provided by the organization directly or indirectly to or for the use of any **disqualified person**, and the value of the economic benefit provided exceeds the value of consideration (including the performance of services) received for providing the benefit. (Treas. Reg. 53-4958-4(a)(1)).
  - A **disqualified person** is a person in a position to exercise **substantial influence** over the affairs of the organization at any time during the five-year look back period from the date of the excess benefit transaction. (Treas. Reg. 53.4958-3(a)(1)).
- The question of disqualification is factual inquiry that looks at actual powers and responsibilities as opposed to titles. Therefore, voting members of a governing body (e.g., directors) and those with the ultimate responsibility for implementing decisions of the governing body (e.g., President) or managing the finances of the organization (e.g., Chief Financial Officer) during the five year look back period would likely be considered disqualified irrespective of their titles in the organization and whether such influence was actually exercised. (See Treas. Reg. 53.4958-3(c)).
- Examples of Excess Benefit Transactions: Loans to and from the organization; compensation for past services
- For more info:
**IRS Considerations**

**Terms: Intermediate Sanctions:**

- Federal excise taxes imposed on the organization, its insiders, or both.
- If an excess benefit transaction has occurred, the IRS can levy taxes, commonly referred to as intermediate sanctions, on both the disqualified person who received the excess benefit and the organizational manager(s) who knowingly approved the excess benefit transaction.

  Pursuant to IRC section 4958, the IRS is authorized to impose the following penalties:
  
  - 25% excise tax of the excess benefit on the disqualified person who received the excess benefit; and an additional 200% excise tax of the excess benefit if the violation is not corrected within the taxable period.
  - 10% excise tax of the excess benefit on the organizational manager who knowingly participated in the transaction (maximum of up to $10,000).

- Historically, the intermediate sanctions have been used as an alternative penalty to revocation under the private inurement doctrine because the penalty of revocation is so severe. However, the IRS can impose both the intermediate sanctions under the excess benefit transaction rules and revoke tax exempt status under the private inurement doctrine for the same unlawful transaction.

- For more info:
  
Transferring Leadership

• Transitions are hard! A bit of knowledge and planning can ease the pain.
• Nonprofits are not “owned” by anyone, so beware of the overbearing founder.
• Transitions are times when you may discover indiscretions, fraud, and/or theft. So, pay attention to warning signs and investigate them. Duty of care!
• Practical tips to transfer leadership:
  o Directors & Officers (volunteer):
    ✓ Stagger Board terms so you never lose everyone at once. Example: All Directors shall serve a three (3)-year term beginning on July 1 and ending on June 30. There shall be staggered terms of office, and Directors may serve no more than two (2) terms. In order to create staggered terms of office, at the March 2016 election approximately one-third (1/3) of the Board of Directors must serve a one (1)-year term, approximately one-third (1/3) of the Board of Directors must serve a two (2)-year term, and the final one-third (1/3) of the Board of Directors must serve a three (3)-year term.
    ✓ Empower a nomination committee to find/vet quality candidates.
    ✓ Be sure to conduct the annual meeting and election process.
  o Officers (hired):
    ✓ Don’t pay excessive severance. This could be considered private inurement by the IRS or an issue for your State’s Attorney General.
    ✓ Do succession planning.
    ✓ Consider “key person” insurance.
    ✓ Consider using an executive search firm to help you find the “right” replacement(s).
    ✓ Lots of nonprofits end up merging/dissolving because they cannot find the right fit when a CEO or Executive Director leaves or retires. Don’t let this be you!
Thank you!!!