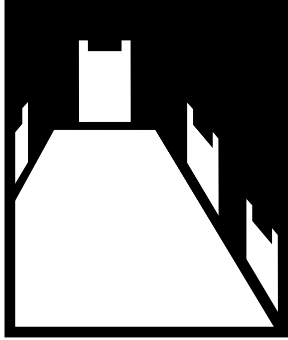

Expectations for Nonprofit Boards are Changing

Do your board members know how the shifting legal environment affects them?

BY EUGENE H. FRAM & ELAINE SPAULL

The Setting: Sally Kent, a professional in her mid-forties, hasn't served on a nonprofit board since her daughters, now nearly college age, were very young. Recently, a nonprofit asked her to join its board. Before deciding whether to accept the offer, Sally invited Ralph Petit, an attorney and neighbor, over for coffee and conversation.

"What's expected of nonprofit board members today?" Sally asked Ralph. "My favorite nonprofit organization has invited me onto its board, and I'd like to accept the offer. But I'm not sure what's required of me."

"Good question," said Ralph. "There have been major changes in nonprofit boards in the past 10 years. I doubt most nonprofit directors are aware—from a legal standpoint—what's expected of them today."

"It looks like I have a lot to learn," said Sally, "but let's start with the basics. Tell me what I need to know."

How Has the Legal Standard Changed?

"First, the legal standard has shifted from the 'trustee' to the 'director' model for nonprofit boards," said Ralph. "In the past, many states viewed nonprofit board members as trustees of a public trust. Under this trustee model, courts could hold board members personally liable for simple negligence *or* gross negligence. Yet courts could hold corporate directors personally liable only for gross negligence. So nonprofit trustees were being held to a different standard from corporate directors. With the new model, nonprofit board members are viewed not as trustees but as directors, with responsibilities much like their counterparts on for-profit boards."

"That makes sense," said Sally. "There are certainly lots of profit-making and nonprofit groups operating in the same industries and functioning in similar ways–groups like hospitals and educational institutions. It seems reasonable to hold both for-profit and nonprofit boards to the same legal standard."

"That's right," said Ralph. "According to this new model, both nonprofit and for-profit directors are measured by the 'prudent person' standard. That means they must perform their duties in good faith, make informed and prudent decisions, and refrain from harming others."

"So what does this change mean for board members?" Sally asked.

"The new model affects the very nature of decision-making on nonprofit boards," said Ralph. "The old trustee model led to more conservative decisions than under the director model. With the new model, for example, nonprofit boards might be more willing to approve a program with major startup costs. They can be more entrepreneurial than boards operating under the 'simple negligence' trustee model. They also might be comfortable allowing management more responsibility. For example, board members might approve written policies that include a little less detail.

"Of course," Ralph added, "policies still must be developed with enough rigor to meet the prudent-person standard. For example, purchase, sale, or distribution of assets should be monitored very carefully. Any distribution or acquisition of assets must have full board discus-

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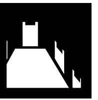


> **Few nonprofit directors are aware—from a legal standpoint—what's expected of them.**

sion with formal approval, and the approval processes must be open and clear. One can't rely on the executive committee to assume these functions, with the full board 'rubber stamping' executive agreements. In fact, some asset sale transactions may even require the approval of the courts or the state attorney general."

How Can Board Members Be Held Personally Liable for Taxes?

"What else should I know about the role of board members today?" Sally asked.

"Another important change is the enforcement of the Intermediate Sanctions Law," Ralph said. "The reason it's so important is that it could result in board members personally being subject to additional taxes."

"That's news to me," said Sally. "You'd better tell me more about this new law."

"Actually, the Act became law in 1996, but it's only now being enforced," said Ralph. "Congress passed the act in response to several scandals involving charitable organizations. The most widely publicized cases involved the national United Way and Adelphi University. In both situations, directors received unusually lucrative salaries and benefits, or what the new act refers to as *excess benefits*. In other words, they used their nonprofit positions to unjustly enrich themselves."

Ralph pulled a document from his briefcase. "Excess benefits," he read, "can be a problem if an organization:

- pays an 'above market' price for an asset;
- pays unreasonable compensations; or
- develops disadvantageous financial arrangements with other organizations. In one case, for example, an outside fundraising group received an excessively generous travel budget from a nonprofit group.

"The IRS punishes nonprofit organizations that permit excess benefits," Ralph went on. "Before the Act, the punishment was removal of the organization's tax-exempt status. When such a step was taken, it involved a difficult legal process, and the real victims were the organization's charitable clients. The Act provides an alternative way to sanction organizations. It also gives the IRS the power to impose personal tax sanctions on individuals who violate the act."

Ralph outlined the provisions of the act. People who aren't allowed to benefit from excess benefits are called *disqualified persons*, he explained. Disqualified persons include organization officers, board members, and their relatives. The disqualified persons' category also can be extended to people not on the staff or board if they can

With the new model, nonprofit boards can be more entrepreneurial.

influence administrative or policy decisions. For example, if a volunteer agrees to chair a program task force, that person may be considered a disqualified person. Major donors also may fall into this category, even if their only role is to provide resources. The legal reasoning is that such people have the ability to exercise substantial influence over the organization.

Disqualified persons receiving an excess benefit can be assessed *personal tax sanctions*, ranging from 10% to 200% of the excess benefit, in addition to repaying the excessive benefit received. Also at risk are board members and managers who knowingly approved an excess benefit. For example, if board members approve compensation for their executive director that is $20,000 higher than the compensation of executive directors of comparable organizations, tax penalties may be imposed. The following illustrates how this works:

Executive Director
$5,000 (25% of the $20,000 excess benefit)
$20,000 timely repayment of the excess benefit
$40,000 if the excess benefit and interest are not paid in a timely manner.

Board Members
10% of the excess benefit, up to maximum of $10,000 for each. In this example, $2,000 each (10% of $20,000).

What Should You Review with Your Board?

At the end of their conversation, Ralph summarized his recommendations for what Sally should review with the board if she accepts the invitation to join:

• **Alert board members** to the provisions of the Intermediate Sanctions Act and the increased potential for board members' liability. Many people who have heard about the Intermediate Sanctions Act know only about the problems of excess benefits at the CEO level. However, any disqualified person, not just a CEO, can become entangled in the Intermediate Sanctions Act web, if proper due diligence isn't exercised. For smaller nonprofits, even offering excess benefits to several managers totaling $50,000 could mean a $5,000 tax for each of the board members approving the benefits.

• **Recommend strict vigilance** for any transactions that could involve a disqualified person. Everyone who might be subject to the Intermediate Sanctions Act needs to have a clear understanding of issues that could be involved in a transaction. This includes influential outsiders such as donors or revenue-sharing organizations.

• **Insist that all compensation and benefits** be reasonable and conform to similar organizations operating under similar circumstances. Recommend that the entire board (or a standing committee) review all compensation schedules, including benefits, before the organization's compensation plan is implemented. This may well be a significant change for your board because the usual approach on nonprofit boards is to delegate the CEO evaluation and compensation task to a few senior board members or to the board's executive committee.

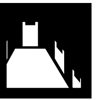
• **Recognize that, in applying the new act, the IRS can request records** for the most recent five-year period. For that reason, the board's audit committee should be sure that management has access to the required records, that all documentation is adequate, and that IRS Form 990 is completed in a clear and concise manner.

• **Ask questions** related to whether excess benefits may be accruing to some disqualified persons whenever issues covered by the Intermediate Sanctions Act (such as compensation schedules, transfer of assets, and so on) arise. Whenever such issues emerge, use outside counsel to assure that all elements meet the "reasonable" principle. (That is, reasonable people viewing the same circumstances would come to the same conclusion.)

• **Recommend that board members and management** have some knowledge of what the IRS calls "safe harbor" provisions. There are three actions the IRS says boards should take before making any decisions that might be construed as involving an excess benefit:

1. **Appoint a group of disinterested board members,** or a formal board committee of disinterested persons, to approve all compensation plans and other transactions that might be subject to the Intermediate Sanctions Act.
2. **Be sure these people base their decisions** on documented, comparable data, gathered by disinterested field experts.
3. **Keep detailed records** of data, meetings, and transactions, in case the IRS needs to see them.

• **Review all directors' and officers' (D&O) liability insurance policies** to be sure these policies cover excess-benefit tax sanctions. If they don't, ask your



underwriter how the policy can be rewritten to include Intermediate Sanctions Act coverage.

• **Every year, have the organization's personnel and outside directors sign** a conflict-of-interest statement to ensure they are informed about potential Intermediate Sanctions Act liabilities. This statement should include a brief description of the Intermediate Sanctions Act.

• **Request that the organization's counsel review** the nonprofit's bylaws to be sure they comply with the Intermediate Sanctions Act. Since the law is so complex, it also may be wise to have counsel review ways of establishing compensation processes and other major transactions.

As he was leaving, Ralph added, "I can't emphasize enough that the Intermediate Sanctions Act will have a serious impact for many years to come. It is a readily available tool for the federal government to use to assure the public that charitable resources are being used for the people who need them."

"Thanks for the advice," said Sally. "I'm leaning toward accepting the invitation to be a board member. But now I'm much more prepared to make informed, prudent decisions–and to avoid paying tax sanctions!" ■

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These resources are available from the Society's Resource Center, 608-274-9777, Ext. 221, www.danenet.org/snpo.

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