Nonprofit Corporate Governance: Overview of Fiduciary Duties
Designed to Accompany May 20, 2021 Presentation:
"Navigating the Line – What to Do When Nonprofit Boards Overstep into Operations"

I. Introduction

Nonprofit organization leaders and managers are not only stewards of the organization's exempt purposes, but also fiduciaries with responsibilities set forth in both common law and statute. These fiduciary duties, of which this handout provides a brief overview, impose legal standards against which actions, and inactions, of directors, officers and/or trustees are measured.

II. Fiduciary Duties under State Law

In most states, the Attorney General is charged with the supervision and administration of charitable trusts and not-for-profit corporations. The powers of state Attorney Generals are typically broad and often include the power to compel an organization to comply with the terms of its certificate of incorporation (i.e., to prevent *ultra vires* acts), to punish directors and officers for acts of mismanagement, and to prevent an organization from conducting activities within the state.

In addition to Attorney General oversight, many state legislatures have enacted statutes that impose certain duties upon directors, officers, and trustees that are responsible for the administration and management of a nonprofit organization and its charitable assets (collectively referred to in this handout as "Nonprofit Leadership"). Some states have instead established fiduciary duties for Nonprofit Leadership through the development of the state's common law jurisprudence. Wherever the source, these duties are most commonly described as the duties of care, loyalty, and obedience.[1] Failure to comply with these duties can have dramatic ramifications for the Nonprofit Leadership as well as the organization itself.

A. Duty of Care

The duty of care requires Nonprofit Leadership to discharge their duties in good faith and with the degree of diligence, care and skill that an ordinary prudent person would exercise under similar circumstances. Put another way, Nonprofit Leadership must exercise oversight sufficient to ensure operations and assets are being properly maintained. For example, a director must regularly attend meetings and review corporate documents, such as the certificate of incorporation, bylaws, mission statement, minutes of meetings, management reports and reports of third-parties prepared for the organization (e.g., tax returns, financial statements, advice of counsel, etc.). A director must also make informed decisions on matters affecting the organization based upon the information that one would ordinarily expect to rely.

State law will often permit Nonprofit Leadership to delegate certain responsibilities and duties to others, subject to certain limitations.[2] In any case where a director delegates his or her duties to another person, such delegation is always subject to the limitation that the director has

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[1] See, for example, Va. Code Ann. § 13.1-870-871, 853 and 873 (West).

[2] Generally, a director may delegate responsibilities or duties if the director determines that the person selected possesses the requisite degree of knowledge and expertise to prepare such returns. Trustees of charitable trusts, however, are usually only permitted to delegate certain investment authority.

acted in good faith. One of the duties that is often delegated by directors is the management of the organization's investments. To that end, nearly every state has adopted its version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which includes specific guidance on delegation and management and investment of nonprofit funds.[3] When delegating this responsibility, directors are generally required to consider the long and short term needs of the organization in accomplishing its purpose, its present and anticipated financial requirements, expected total return on its investments, price level trends and general economic conditions. If investment authority is delegated, the directors of an organization may be protected from liability resulting from a failure of investment performance if the board of directors has acted in accordance with its duty of care in selecting the delegate and defining the scope of the delegate's authority.

In connection with the duty of care, many states recognize the "business judgment rule," such that nonprofit corporations and Nonprofit Leadership are free from frivolous lawsuits by assuming that, unless proved otherwise, management is acting in the interests of the corporation and managers will not make optimal decisions all the time. The business judgment rule provides that a director who has exercised his or her duties will not be held liable for adverse consequences resulting from the exercise of his discretion. This doctrine is based upon the notion that a director should not be held accountable for results that, though not intended, occur despite the director's exercise of his or her duties. In other words, a director will not be held liable for failures that result from their decisions if, when the decision was made, the director acted in good faith and exercised his or her duties to the organization.[4]

B. Duty of Loyalty

The duty of loyalty requires Nonprofit Leadership to refrain from using his or her position to derive personal benefits that should otherwise inure to the organization. State laws that establish this duty are often found in the form of laws prohibiting and/or regulating conflicts of interest.[5] Conflict of interest laws generally provide certain circumstances in which a nonprofit organization may void a contract or other agreement entered into by the organization with a director or some related party who has a material interest in the transaction. For the conflict to be waived, the interested director is usually required to disclose the material interest to the organization's Board of Directors, the disinterested members of which then vote on whether to approve the transaction. If either the notice or the vote was not properly carried out, a nonprofit can usually void the agreement unless it is proven that the agreement was fair at the time the agreement was approved.

C. Duty of Obedience

The duty of obedience obligates Nonprofit Leadership to ensure that the mission of the organization is carried out. This duty requires Nonprofit Leadership to act in accordance with the governing documents of the organization, including its certificate of incorporation, as amended from time to time, as well as its bylaws and policies. State law generally prohibits a nonprofit from engaging in acts outside the authority of the organization unless such action is approved by

[3] See https://www.uniformlaws.org/committees/community-home?CommunityKey=043b9067-bc2c-46b7-8436-07c9054064a3 for more information on UPMIFA and its adoption in 49 states.

[4] Trustees of a charitable trust are not permitted to rely on the business judgment rule.

[5] See, for example, Va. Code Ann. § 13.1-871 (West).

a court.[6] When such action is taken, the state's Attorney General may seek to dissolve the organization for such violation.

III. Fiduciary Duties under Federal Law

While volunteer Nonprofit Leadership is provided with conditional immunity from personal liability by the Volunteer Protection Act of 1997,[7] violations of fiduciary duties by directors, officers and/or trustees can risk a nonprofit organization's ability to operate its programming and even its tax-exempt status

A. The Internal Revenue Code

In addition to state law, federal law includes several provisions that indirectly address the duty of loyalty owed by Nonprofit Leadership to a nonprofit organization. These provisions include, but are not limited to, the (i) "operational test" required under the Regulations to Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code") and (ii) prohibitions on excess benefit transactions and self-dealing.

Nonprofits must be organized exclusively and operated primarily for one or more exempt purposes specified in Section 501(c)(3) of the Code (e.g. religious, educational, charitable). Although not explicitly referenced in the statute, an organization fails the operational test if it confers private benefits on individuals that are more than incidental, quantitatively and qualitatively, to the furthering of its exempt purposes (the "public benefit doctrine"). While the distinction between public and private benefit can be subtle and varies based on facts and circumstances, Nonprofit Leadership that allow the operation of the nonprofit in a manner that violates the private benefit doctrine likely are in breach of their fiduciary duty of loyalty and may jeopardize the organization's tax-exempt status under federal law.

The Code also provides other complex rules to address improper benefits flowing to individuals vs. furthering exempt purposes, including prohibiting excess benefit and self-dealing transactions with a nonprofit's "disqualified persons".[8] For example, if a disqualified person receives an economic benefit provided by a public charity that exceeds the value of benefits provided to the organization by such disqualified person, the transaction will be treated as an excess benefit transaction. When an excess benefit transaction occurs, a penalty tax is imposed on the disqualified person in an amount equal to 25% of the excess benefit and 10% (limited, however, to $10,000) on the director, officer or trustee who knowingly acted on behalf of the organization.

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[6] See, for example, Va. Code Ann. § 13.1-828 (West). See also, *Norton Grocery Company v. Bank*, 151 Va. 195, 202, 144 S.E. 501, 502-03 (1928) (holding that when a contract is *ultra vires* in the proper sense it is not only voidable, but wholly void and of no legal effect).

[7] The Volunteer Protection Act of 1997 (the "VPA") provides a conditional immunity for volunteers, including officers, directors and trustees, who perform services for a nonprofit organization and who do not receive compensation from the organization in excess of $500 per year. Immunity under the VPA protects volunteers against personal liability for harm they cause while acting within the scope of their responsibilities on behalf of the organization, so long as the harm is not caused by: (i) willful misconduct, (ii) gross negligence, (iii) reckless misconduct, (iv) operating a motor vehicle, vessel or aircraft for which a license or insurance is required, or (v) a conscious, flagrant indifference to the rights or safety of the person harmed. Although the VPA provides a defense to liability for volunteers who meet certain criteria, it does not prohibit lawsuits from being filed.

[8] Generally, individuals and entities who exert substantial influence on the organization or are related to those that do or who are substantial contributors to the organization.

If an excess benefit transaction is not corrected within certain specific time limits, the penalty tax on the disqualified person is increased to 200% of the excess benefit.

The excess benefit transaction rules, however, do not apply to private foundations. Instead, the rules against self-dealing apply. In short, the rules against self-dealing prohibit virtually any transaction between a private foundation and its disqualified persons, even if the deal is at arm's length or if the private foundation is receiving a bargain.[9] Self-dealing also brings taxes on the self-dealer and the foundation's managers that increase if the transgressions are not corrected.

B. Public Inspection Laws

All charitable organizations are subject to federal public inspection laws. These laws provide that any person (with a few minor exceptions) is entitled to obtain copies of an organization's application for tax exemption (which includes all documents of formation, such as certificate of incorporation, bylaws and/or trust agreement), as well as the current and previous three years of annual information returns. If an organization is classified as a private foundation, then the names and addresses of each of the organization's contributors are also open to public inspection (as well as the amount contributed).

As a practical matter, a request for inspection could be made either to the organization itself, or to the Internal Revenue Service. If a request is made to the Internal Revenue Service, they will provide the applicable documents. Even if a request is not made to the organization or to the Internal Revenue Service, the annual tax returns for most organizations are published on the internet and are available to any person interested in such information. Among other things, the tax return will disclose: (i) the names and addresses of all officers and directors, (ii) if the organization is classified as a private foundation, the name of each contributor, along with their address and amounts of contribution, and (iii) the amount of any economic benefits provided to related parties.

C. Annual Filing Requirements

Nonprofit Leadership is also required to comply with certain filing requirements. For example, not-for-profit corporations must, unless certain limited exceptions apply, file an information return (e.g., Form 990 or Form 990-PF) each year.[10] Directors who fail to comply with a demand of the Internal Revenue Service for such information returns may be held liable for such failures unless reasonable cause can be established. These rules also apply to information returns that are filed in an incomplete or incorrect manner. Directors may also be held accountable for a

[9] See Section 4941 of the Code and associated Regulations for more on private foundation excise taxes for self-dealing.

[10] Most states also impose registration requirements similar to requiring the filing of annual information returns. Typically states require nonprofits to register with the Attorney General's office of the state in which they are located, as well as in each of the states in which charitable solicitations are made. When registration is required, not-for-profit corporations are usually required to file annual reports disclosing information in connection with the prior year's solicitations, as well as financial information that is typically included in the organization's annual information return filed with the Internal Revenue Service. If an organization fails to file these reports, state law often imposes financial penalties, along with the possible loss of authorization to conduct activities in the state. With respect to the financial penalties for failing to file, directors are often held personally liable for the penalties.

not-for-profit corporation that fails to file returns and make payments with respect to FICA taxes in connection with the organization's employees.

IV. Conclusion

Effective corporate governance requires dedicated focus on the part of directors, officers, and/or trustees to understand their respective roles and responsibilities required under state and federal law. It is imperative that nonprofit organizations regularly review developments in state and federal law with a critical eye to understand how nonprofit corporate governance issues are continuing to evolve and develop. Furthermore, nonprofit organizations should proactively train and educate their leaders and managers on issues pertaining to corporate governance so all parties are on the same page and aware of best practices.