

OVERVIEW FOR DIRECTORS OF NOT-FOR-PROFIT CORPORATIONS

Kenneth P. Friedman
Hodgson Russ LLP
The Guaranty Building
140 Pearl St. Suite 100
Buffalo, New York 14202
(716) 848-1279
kfriedma@hodgsonruss.com

Patricia C. Sandison
Hodgson Russ LLP
The Guaranty Building
140 Pearl St. Suite 100
Buffalo, New York 14202
(716) 848-1619
psandiso@hodgsonruss.com

I. GENERAL FRAMEWORK AND TERMINOLOGY

A. State law

1. In New York, churches must incorporate under the Religious Corporation Law, and museums, schools, and historical societies must generally incorporate under the Education Law. Most other organizations incorporate under a set of statutes known as the New York Not-for-Profit Corporation Law (“NPCL”).
2. **Members** (equivalent of shareholders): Be cognizant of whether your organization has Members, with rights under the NPCL. Some organizations have members (such as in exchange for an annual donation, you achieve membership status which allows you to attend the museum for free or a reduced rate all year) – this is not the same as having Members under the statute. Real Members generally appoint directors, and have other statutory powers (e.g., member approval is required to amend the Certificate of Incorporation).
3. **Certificate of Incorporation:** A not-for-profit corporation’s Certificate of Incorporation is on file with the New York State Secretary of State’s office. The Certificate of Incorporation specifies the name of the corporation and its purposes, among other things. Any changes to the Certificate of Incorporation must be made by filing an Amendment to the Certificate of Incorporation with the Secretary of State’s office. A copy of such Amendment also must be attached to the corporation’s next IRS filing. **It is very important that an organization operates at all time within the exempt purposes and activities provided for in its Certificate of Incorporation.**

4. **Bylaws:** Not-for-profit corporations adopt bylaws, which are a set of internal rules that describe its corporate structure and governance (i.e., whether it will have members (and if so, who they will be), how directors will be selected, the length of their terms, the duties of officers, etc). Bylaws are not filed with the Secretary of State. Changes in bylaws may need to be attached to the corporation's next IRS filing.

B. Federal law

Not-for-profit corporations may apply to the IRS for a determination that they qualify as tax-exempt organizations, such as those described in Section 501 of the Internal Revenue Code. Exempt organizations must comply with various federal tax laws.

1. **501(c)(3) organizations:** can be corporations, trusts, LLCs, unincorporated associations.

(a) Definition

(i) organized and operated **exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes**, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or the prevention of cruelty to children or animals;

(ii) no part of the net earnings inures to the benefit of any private shareholder or individual;

(iii) no substantial part of activities is carrying on propaganda or otherwise attempting to influence legislation;

(iv) does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for elective public office.

2. **Other categories:** include IRC §§ 501(c)(1) - (c)(28), such as:

501(c)(4): civic league/social welfare

501(c)(6): business league/chamber of commerce/trade association

501(c)(7): social club

501(c)(8): fraternal beneficiary societies operating under the lodge system

3. Political Organizations (IRC § 527)

II. BOARD OF DIRECTORS OF NOT-FOR-PROFIT CORPORATION

- A. From a legal perspective, the role of “director” is defined in the NPCL. The basic premise of the NPCL is that a not-for-profit corporation is managed by its board of directors acting as a body. **Individual directors have no power to take action on behalf of the corporation; only the board as a whole can do that.**
- B. Not-for-profit corporations must have at least 3 directors. Education corporations must have 5 - 25 trustees. The rules for number of trustees of Religious corporations vary depending on type.
- C. The board can delegate responsibilities, e.g., to committees or employees, but it is ultimately responsible for the workings of the corporation. The following actions cannot be delegated - they must be taken by the board itself:
- certain major actions, such as a plan for merger or consolidation (NPCL § 903(a)), a plan for dissolution and distribution of assets (NPCL § 1002(a)), or a transaction disposing of substantially all assets (NPCL § 510(a)(1)); if the corporation has members, member approval also is required
 - filling of board or committee vacancies
 - fixing of directors’ compensation
 - changing the number of directors (NPCL § 702(b)(1))
 - removal of a director from office (NPCL § 706(a))
 - amendment of the certificate of incorporation (NPCL § 802(a)(2))
 - amendment or repeal of bylaws or adoption of new bylaws
 - amendment or repeal of any board resolution that, by its terms, can be amended or repealed only by the full board (NPCL § 712(a)).

III. DUTIES AND STANDARD OF CONDUCT OF DIRECTORS

A. **Duty of Care** – “NOT JUST A RUBBER STAMP”

Directors of a not-for-profit corporation are required to discharge the duties of their positions **in good faith, with the degree of diligence, care and skill that an ordinarily prudent person would exercise under similar circumstances in like positions** (NPCL § 717(a)). In large part, this means using common sense, practical wisdom and informed judgment. The law does not penalize directors for an incorrect decision so long as that decision was reasonably and prudently made, i.e., it was carefully considered, outside advice was sought where necessary, there

was open and frank discussion, and after all of that the directors reached a decision in good faith. The standard is applied separately to each situation. For example, a board whose directors have special knowledge, such as financial expertise, may be held to a higher standard of care.

Directors may rely on advice from others and on the corporation's financial statements where those have been properly prepared, but such reliance is governed by the same good faith, prudent person standard.

Absent judicial inquiry for bad faith and self-dealing, there are virtually no reported cases where Directors have been held personally liable to breach of duty of care (even for D's completely asleep at the switch—judges are very wary of enforcing this).

B. Duty of Loyalty – THE CORE OF WHAT IT MEANS TO BE A FIDUCIARY → “Subordinate your private interests to those of the NFP”

Directors must vote and make decisions based on the **best interest of the entire organization**, not on the basis of personal preference or personal gain. Corporations should have a conflict of interests policy under which any such conflicts are brought to the attention of the full board and an interested director is required to abstain from discussions and voting on the issue.

UPDATE: Under the new law (The NY Non-profit Revitalization Act), effective July 1, 2014, all NY nonprofit corporations are required to have a conflict of interest policy in place and are prohibited from entering into “related party transactions” unless the Board determines each such transaction to be fair, reasonable and in the best interest of the corporation.

The NPCL prohibits self-dealing. A corporation may not make loans to its officers or directors. Also, if the corporation does business with another entity in which a director has an interest, that interest must be fully disclosed or the arrangement between the two entities can be voided.

Corporations that are exempt from federal tax also are subject to IRS rules regarding transactions between the corporation and an officer or a director (or relatives of or businesses owned by an officer or a director). In such transactions, the other party cannot pay less than, or receive more than, fair market value. For private foundations, such transactions are completely prohibited.

Confidentiality is also a part of a director's duty of loyalty. Matters discussed or decisions taken at Board or committee meetings are confidential to the corporation and should not be disclosed outside the Board until there has been a general public disclosure or unless the information is a matter of public record or common knowledge. Directors are not spokespersons for the corporation. Disclosure to the public of corporate activities should be made only through the corporation's designated spokesperson.

C. Duty of Obedience –

Directors' actions must conform to external laws, such as federal, state and local laws and regulations, and to its own internal laws, such as its Certificate of Incorporation, bylaws, and policies and procedures.

“Use Organization’s assets for stated purposes”

D. To whom are directors accountable?

1. The corporation - it is a director’s responsibility to protect and advance the corporation’s interests.
2. Constituency served by the corporation, i.e., those to whom the corporation’s purposes are directed. It is a director’s responsibility to act for the benefit of the entire constituency, not just a particular group of beneficiaries or other directors.
3. The public at large, and ultimately New York State.

IV. DIRECTOR RESPONSIBILITIES AND PROCEDURES

- A. Directors should attend board and committee meetings regularly and carefully review all material prepared for or reviewed at these meetings, such as committee reports and financial reports. A director is held responsible for all actions of the board, whether or not she was present at the meeting where the action was taken, unless she voted against the action or went on record as objecting.
- B. In order to prove that a board is operating correctly, it is important to keep good minutes and other records and to develop a strong system of periodic reporting from committees to the board and, if the corporation has members, from the board to the members.
- C. It also is important that the corporation take its actions properly and pay attention to the procedural rules described in its bylaws. For example:
 1. Meetings must be held on proper notice or with a signed waiver of notice. **Under the new law, starting July 1, 2014, e-mail notice to (and e-mail waivers of notice from) directors and members will be permitted.**
 - 2.. A meeting cannot be called to order unless there is a quorum of directors present, and votes cannot be taken unless there is a quorum present at the time of the vote.
 3. The only way action can be taken without a meeting is by unanimous written consent. Telephone polls are not valid (but directors can be present

at a meeting via conference telephone or video screen communication, i.e., where all participants at the meeting can speak and can hear each other). **Under the new law, starting July 1, 2014, e-mail “signature” of written consents by directors and members will be permitted.**

4. Directors cannot vote by proxy; they must be present at the meeting in person or by conference telephone. Members can vote by proxy.

V. SPECIAL REQUIREMENTS IN FINANCIAL AREA

- A. The board may put any money raised or accumulated by the corporation into one or more accounts for the exclusive use, benefit or purposes of the corporation. **Where money was received for a specific purpose, the board must use those funds only for the specified purpose.** Management of the corporation’s funds is subject to the standards of good faith and care set forth above.
- B. The board may delegate to committees, officers, employees or agents, including outside investment counsel, the authority to act for the board in investment of institutional funds. The board must oversee the management of the corporation’s funds using the same standard of care as outlined above. The standard of care applies to the selection of a manager as well as to actual financial management. The NPCL provides that “the governing board shall be relieved of all liability for the investment and reinvestment of institutional funds by, and for the other acts or omissions of, persons to whom authority is so delegated or with whom contracts are so made.”
- C. The NPCL sets out the following economic factors directors should weigh when making decisions on investments and administration of assets:
 - long- and short-term needs of the corporation
 - present and anticipated financial requirements of the corporation
 - total return on investments
 - price level trends
 - general economic conditions

VI. DIRECTOR AND OFFICER LIABILITY

- A. Directors and officers are not personally liable for the debts, liabilities or obligations of the corporation if they fulfill their duties properly. However, if they fail to exercise the standards of care, loyalty and obedience, they may be personally liable:
 1. to the corporation itself;
 2. to creditors who are unpaid as the result of a waste of assets by the directors;

3. to members or “clients” who paid for goods and services they did not receive as a result of waste or improper management;
 4. to other directors charging waste and improper management.
- B. Directors and officers may be personally liable for the following:
1. amounts collected from others on behalf of the government but not paid over (e.g., employee withholding and FICA, sales tax);
 2. unpaid workers’ compensation or unemployment insurance relating to employees;
 3. unpaid wages and benefits, including failure to pay required overtime.
 4. penalties for failure to file annual required information returns;
 5. excise taxes on excess benefits paid to “disqualified persons”;

VII. INDEMNIFICATION AND EXCULPATION

- A. Not-for-profit corporations typically indemnify directors and officers against the reasonable expenses, including attorneys’ fees, that they actually and necessarily incur to defend or appeal an action, unless the director or officer is judged to have breached her duty to the corporation. Corporations may obtain directors’ and officers’ liability insurance to fund such indemnification. There is NO indemnification if the officer or director is guilty of personal negligence, e.g., did not act in good faith or did not reasonably believe his or her actions to be in the best interest of the corporation.
- B. Under NPCL § 720-a, a volunteer (uncompensated) officer or director of a 501(c)(3) organization is not liable to any person based solely on her conduct in the execution of her office unless her conduct constituted gross negligence or was intended to cause the resulting harm. This section does not protect a director or officer against an action brought by the corporation itself, derivative actions brought in the name of the corporation, or actions for grossly negligent or intentional acts.
- C. Under the federal Volunteer Protection Act of 1997, a volunteer director or officer is not liable to third parties for harm he or she causes if the officer or director:
1. was acting within the scope of his or her responsibilities;

2. did not cause the harm by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individuals harmed;
3. was not engaging in conduct that constitutes a violation of civil rights law, a hate crime, a crime of violence, or a sexual offense; and
4. was not under the influence of alcohol or drugs.

Again, this law does not protect a director or officer against an action brought by the corporation itself, derivative actions brought in the name of the corporation, or actions for intentional torts, gross negligence, etc.

VIII. TAX RULES, LOBBYING AND POLITICAL ACTIVITIES

- A. New York State requires most charities to register with the Attorney General's Charities Bureau and to file annual information returns. There also are registration requirements for use of professional fundraisers and arrangements with "commercial co-venturers."
- B. Not-for-profit corporations that claim exemption from federal income tax (under section 501(c)(3) or other sections) are subject to certain requirements under federal tax law.
 1. Tax exempt organizations are required to file annual information returns (**Form 990**, or 990-PF for private foundations) with the IRS. Organizations other than private foundations that have annual income of less than \$25,000 have been exempt from the annual filing requirement, but starting this year organizations of this type are required to file an "e-postcard" to provide certain minimal information to the IRS.
 2. **Lobbying:** No substantial part of the activities of a 501(c)(3) organization may constitute carrying on propaganda or otherwise attempting to influence legislation. There is a safe harbor based on percentages of total expenditures if certain procedures are followed.
 3. **Political campaigns:** A 501(c)(3) organization cannot participate in any manner in a political campaign for elective public office.

IX. YOUR ROLE AS A LAWYER ON THE BOARD

Non-profits are under increasing scrutiny by "charity watchdogs" such as Charity Navigator and Better Business Bureau/Wise Giving as well as by the IRS and state regulators. To ensure that they live up to their own aspirations as well as meet external demands, organizations should adopt policies to deal with conflicts of interest, investment and management of funds, document retention, and protection of whistle blowers. **Effective July 1, 2014, the new law requires that**

every nonprofit in NY adopt a conflict of interest policy and every nonprofit with 20+ employees and over \$1M adopt a whistleblower policy.

Lawyers have an important role to play in ensuring that the organizations they represent “own” their bylaws and other policies and understand the role of these policies and procedures in building and maintaining a healthy organizational culture.

WEB SITES

- **New York Attorney General:** www.oag.state.ny.us (click on “charities”)
- **IRS:** www.irs.gov
- **Guidestar:** www.guidestar.org (includes copies of organizations’ Forms 990 and other information)