



Director Duties; Liability; and Best Practices When Sitting on an Iowa Nonprofit Board

LeadingAge Iowa

Ed McIntosh
Dorsey & Whitney LLP
801 Grand Avenue, Suite 4100
Des Moines, IA 50309
(515) 699-3272
mcintosh.edwin@dorsey.com



Outline of Presentation

- **Duties of Directors**
- **Personal Liability as a Director and Proactive Steps You Can Take**
- **Best Practices to Improve Effectiveness**
- **Questions**

Critical Issues for Individuals Serving on Nonprofit Boards



Nonprofit Corporation Board of Directors' Duties

- **Business affairs of a nonprofit corporation must be managed by or under the direction of the Board of Directors. Iowa Code §504.801**



Nonprofit Corporation Board of Directors' Duties

- ✓ Clarify mission and assure it is carried out – importance of mission statement/disclosure on Form 990
- ✓ Participate in development of strategic plan/oversee its implementation
- ✓ Annually review performance against strategic plan
- ✓ Approve annual budget and major transactions (full board reviews budget not committee)
- ✓ Oversee management but not directly manage
- ✓ Select, evaluate, remove the Executive Director
- ✓ Act in accordance with fiduciary duties (in good faith and in a manner the director reasonably believes is in the best interests of the corporation)
- ✓ Oversee (not rubber stamp) board committees and staff recommendations
- ✓ Add individual perspective/experience/judgment
- ✓ Ensure financial solvency
- ✓ Oversee governance policies



Fiduciary Duties

- **Directors of a nonprofit corporation have three fiduciary duties:**
 - **Duty of Care** - be informed, actively participate in discussions and ask questions (you may rely on dependable sources).
 - **Duty of Loyalty** - act honestly and in good faith (disclose and abstain where conflict of interest).
 - **Duty of Obedience** - obey the law and the organization's governing documents and policies.



Personal Liability as a Director

"Except as otherwise provided under law, directors are not liable for the corporation's debts or obligations and are not personally liable to any person for any action taken or failure to take any action in the discharge of the director's duties except liability for any of the following:

- a. The amount of any financial benefit to which the person is not entitled.
- b. An intentional infliction of harm on the corporation or the members.
- c. A violation of Iowa law governing liability for unlawful distributions.
- d. An intentional violation of criminal law."

Iowa Code §504.901

Critical Issues for Individuals Serving on Nonprofit Boards



Personal Liability as a Director

A director shall not be liable to the corporation or its members for any decision to take or not take action, or any failure to take any action, as director, unless the party asserting liability in a proceeding establishes both of the following:

1. That both the Revised Iowa Nonprofit Corporation Act and the corporation's articles of incorporation do not preclude liability, and
2. That the challenged conduct consisted of or was the result of one of the following:
 - a. Action not in good faith
 - b. A decision that is one of the following:
 - i. That the director did not reasonably believe to be in the best interests of the corporation;
 - ii. As to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances
 - c. A lack of objectivity due to the director's familial, financial, or business relationship with, or lack of independence due to the director's domination or control by another person having a material interest in the challenged conduct.
 - d. A sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention, by making, or causing to be made, appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefor.
 - e. Receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its members that is actionable under applicable law.

See Iowa Code §504.832 governing standards of liability for directors.



Personal Liability as a Director: ERISA

Personal Liability:

- Federal and state laws governing retirement plans, health insurance and other benefits are generally subject to ERISA.
- Under ERISA, directors and officers face personal liability with respect to these plans (because they are usually fiduciaries with respect to these plans).
- D&O insurance often excludes coverage of liabilities under ERISA.



Personal Liability as a Director: ERISA

Proactive Steps:

- Purchase an ERISA rider to the nonprofit's D&O insurance.



Personal Liability as a Director: Approving Unreasonable Compensation

Proactive Steps:

Establish a Rebuttable Presumption of Reasonableness.

- Compensation is approved by the Board or a committee composed of individuals without a conflict of interest.
- Board relied on appropriate data as to the compensation's reasonableness.
- Board adequately documents the basis for its determination at the time it makes determination (not "after the fact").

Critical Issues for Individuals Serving on Nonprofit Boards



Personal Liability as a Director: Federal Protection - Statute

- **Federal Volunteer Protection Act (the “VPA”) protects uncompensated directors from civil liability:**
 - **Must be uncompensated** (reasonable expenses OK; nominal reimbursement)
 - **Limits punitive damages and limitation of liability for noneconomic losses** such as pain, suffering, and loss of consortium
 - **Doesn’t cover:**
 - willful or criminal misconduct
 - gross negligence
 - reckless misconduct and flagrant indifference to the rights or safety of the individual harmed
 - Harm caused by a motor vehicle, vessel, aircraft
 - **But**
 - Doesn’t protect a nonprofit organization from liability
 - Doesn’t prohibit lawsuits against a volunteer, i.e., the cost of defending such an action is still the responsibility of the director



Personal Liability as a Director: State Protection – Mandatory Indemnification; Permissive Expenses Advanced

Under Iowa law, a corporation *shall* indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which the director was a party because the director is or was a director of the corporation against reasonable expenses actually incurred by the director in connection with the proceeding. Iowa Code §504.853.

Additionally, the corporation *may*, before the conclusion of a proceeding, advance funds to pay for or reimburse the reasonable expenses incurred by a director who was a party to such proceeding if the director delivers all of the following to the corporation:

- a. A written statement of the director’s good faith belief that the director has met the relevant standard of conduct described under Iowa law or that the proceeding involved conduct for which liability has been eliminated under the articles of incorporation; and
- b. The director’s written undertaking to repay any funds advanced if the director is not entitled to mandatory indemnification under Iowa law and it is ultimately determined that the director has met the relevant standards of conduct.

Iowa Code §504.854



Personal Liability as Director: Protection-Indemnification and Insurance Provided in Governing Documents

An Iowa nonprofit may indemnify directors against liability when the director acted in good faith and reasonably believed the conduct was in the best interests of the corporation/not opposed to the best interests of corporation/no reason to believe conduct was unlawful.

Governance documents can provide indemnification and insurance.

Iowa Code §504.859



BEST PRACTICES - Board Composition

Identify the various skills needed for effective board oversight; assess whether board composition is appropriate and adjust board (and/or committee) composition as needed



BEST PRACTICES – Board Composition (cont'd)

- **Directors bring a range of experience, diversity, knowledge and judgment (financial literacy is important) to the organization.**
- **The Board needs to proactively monitor on an ongoing basis whether the Board has the necessary tools to perform its oversight function effectively (not just take someone because of their willingness to serve).**
- **Board members should not serve as the Chair/President and Treasurer simultaneously.**



BEST PRACTICES – Define Responsibilities

Clearly define and communicate the respective roles of the Board, committees and senior management



BEST PRACTICES – Define Responsibilities (cont'd)

- Establishing committees can improve the Board's effectiveness, particularly if the Board is large.
- Committees are subject at all times to the direction and control of the Board. The Board must clearly define the scope of responsibility of the committees (e.g., whether the committee has board delegated authority or has the authority only to make a recommendation to the Board).
- Although directors will have varying opinions about issues, Board members must operate "as a team" and "speak with one voice" once a full discussion has taken place and a decision has been made.



BEST PRACTICES – Internal Controls

Establish a system of internal controls that require senior management to inform the Board of significant transactions



BEST PRACTICES – Internal Controls (cont'd)

- **Adopt a policy outlining the types of transactions that need Board (or a Board committee) approval.**
- **Adopt a policy to ensure that no person bears the sole responsibility for receiving, depositing and spending the organization's funds.**
- **Board should consider requiring that the CEO certify (or at least review) the financial statements of the organization and the Form 990.**



BEST PRACTICES – Engaged Board

Empower the Board to ask the “hard questions” by educating the Board members about their fiduciary duty to be fully informed and to make necessary inquiry



BEST PRACTICES – Engaged Board (cont'd)

- **Meet regularly.**
- **Board should receive reports from committees and senior management sufficiently in advance of meetings for the Board to review and consider the contents of the reports.**
- **While the Board of Directors is permitted to rely on information, opinion and reports prepared by others, they cannot avoid their responsibilities. Board members need to actively question management and outside advisors when they see a “red flag.”**
- **Board members should be not only encouraged, but required, to ask the hard questions.**
- **Board must be careful to retain the necessary oversight over committees and not rubber stamp committee or senior management’s recommendations.**



BEST PRACTICES – Self Evaluation

Establish and implement an effective annual self-evaluation mechanism (including the opportunity for anonymous input) for the Board to review its performance and the performance of its committees



BEST PRACTICES – Self Evaluation (cont'd)

- **A meaningful evaluation requires a review of the effectiveness of the Board, the committees and the individual Board members.**
- **Focus on whether Board members are able to effectively exercise the required oversight and seek improvement.**



BEST PRACTICES – Feedback mechanism

Adopt a whistleblower policy and establish an appropriate anonymous means for employees and others to report compliance concerns



BEST PRACTICES – Feedback mechanism (cont'd)

- **Board should ensure that there is an appropriate and effective means for employees to report compliance concerns and make sure concerns are addressed.**
- **Strongly suggested by new Form 990.**



BEST PRACTICES – Conflict of Interest

- **Board members shall complete conflict of interest disclosure forms in a timely manner.**
- **Board members with a conflict shall disclose the conflict and abstain from voting on the transaction (if appropriate, leave the room so Board can discuss freely).**
- **If the Board decides to enter into a transaction with a party that has a conflict, Board members should document that they have explored the same transaction with unrelated parties and established why this transaction with a related party furthers the organization's charitable purposes.**
- **Important to address "appearance" of conflict of interest.**
- **Consider whether to extend to certain staff.**



BEST PRACTICES – Establish an Audit Committee

Establish a Board audit committee comprised of Board members to oversee financial reporting, risk assessment and management practices



BEST PRACTICES – Establish an Audit Committee (cont'd)

- **The Audit Committee shall engage auditors, review audit plans, and review financial statements, accounting policies and internal compliance programs, as well as tax, legal and regulatory matters.**
- **Members of Audit Committee should meet financial literacy standards (have accounting and financial management background/expertise).**



BEST PRACTICES – Oversee Finances

**Oversee finances, manage and spend
organization's funds appropriately**



BEST PRACTICES – Oversee Finances (cont'd)

- **Use organization's funds in a responsible, effective and efficient manner to further the organization's mission.**
- **Board shall approve operating budget prior to beginning of each fiscal year.**
- **A nonprofit should ensure that it expends a significant percentage of its annual budget on programs that further its charitable purpose.**
- **The Board, either directly or through a board-authorized committee should ensure that the organization's funds are appropriately accounted for by regularly receiving and reviewing up-to-date financial statements and any auditor's letters or finance and audit committee reports, e.g., at least quarterly.**



BEST PRACTICES – Be Transparent

**Be transparent to the public about your programs,
governance and finances**



BEST PRACTICES – Be Transparent (cont'd)

- **Ensure that the organization's Form 990 (the IRS Information Return) accurately describes the organization's programs and finances.**
- **Required to make available Form 1023 exemption application, Form 990, and Form 990-T (for unrelated business income), available for public inspection.**
- **The Internal Revenue Service encourages every charity to adopt and monitor procedures to ensure that its Form 1023, Form 990, Form 990-T, and financial statements, are complete and accurate, are posted on its public website, and are made available to the public upon request.**



BEST PRACTICES – Follow Policies

- **Make sure your organization follows its policies, procedures and audit recommendations.**
- **The Board should monitor management's compliance with such policies, procedures and recommendations.**