

Governance Resources

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The Legal Obligations of Not-for-Profit Boards

by Linda B. Miller, President, Volunteer Trustees Foundation

The Great Boards website is pleased to offer this article to help orient and educate governing board members about their legal obligations.

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Trustees are on the line; they are guardians of our most cherished institutions; they bear responsibility for society's most vulnerable members; they are the keepers of community dollars, aspirations and hopes. With the privilege to serve come legal obligations derived from trust law and enforceable by the state attorney general. All directors are legally bound by the duties of obedience to charitable purpose, due care and loyalty.

Serving as a director of a not-for-profit institution is both a privilege and a responsibility. It affords the opportunity to make a difference in your community, but it also confers on each director a set of legal obligations that derive from the laws that govern charitable institutions. Directors, or *trustees*, are entrusted with the oversight and management of charitable assets which exist for the public benefit. Tax-exemption is tied to a specific public purpose set forth in the articles of incorporation.

Unlike boards of for-profit companies, where directors are responsible to stockholders, not-for-profit directors have a more complicated allegiance. Charitable institutions are not owned by individuals, but belong to the community at large. The needs of the institution must constantly be

weighed against the needs of the community. A profitable hospital, for example, that is not actively re-investing in an ailing community may be an institution in breach of its mission.

Fiduciary Duties

The fiduciary obligations of not-for-profit directors require that they:

- make decisions that are in keeping with the defining mission or purpose of the organization;
- make judgments in good faith; and
- assure that the assets of the institution do not unfairly accrue to the personal gain of any individuals.

“It appears that the Board confused preservation of the Hospital with preservation of the Board, when the appropriate calculus should be what is good for the Hospital is good for the Board.”

Judge Bernard Fried, Supreme Court of the State of New York, in overturning the board's decision to sell Manhattan Ear, Eye and Throat Hospital, because it failed to consider other strategic alternatives that would have preserved the hospital's original, charitable purpose.

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These three core obligations are defined in law as: the duty of obedience to charitable purpose; the duty of due care; and the duty of loyalty.

The Duty of Obedience to Charitable Purpose

Obedience to the charitable purpose of the organization is the paramount duty of directors. Every not-for-profit organization is created with a public purpose which is defined in the articles of incorporation and which is the rationale for tax exemption and other special tax treatment. Localities and federal and state governments forgo a major source of tax revenue such as property and income taxes, in exchange for the public benefit mission of the charitable organization. Every decision a board member makes concerning the use of assets must further the organization's public purpose. Ventures that deviate from the charity's mission may constitute a breach of trust.

The Duty of Due Care

The duty of due care refers to the director's obligation to exercise diligence in making decisions involving charitable assets. Directors may delegate responsibility for decision-making to qualified board committees or rely on the advice of experts, but directors are never free of the obligation to conduct reasonable inquiry and due diligence be-

"I didn't have time to look into this matter, is not an excuse; it is an admission of liability."

James R. Schwartz, from his book,
Health Care Alliances: A Handbook for Nonprofit Trustees, Jossey-Bass, 1999

fore reaching a decision. The business judgment rule, a legal construct, protects directors from liability for business decisions that turn out badly if those directors can demonstrate they acted in good faith, considered all relevant facts, and delegated decision-making to qualified, unconflicted individuals.

The Duty of Loyalty

The duty of loyalty precludes directors from taking advantage of their position to enrich themselves, their families, or businesses at the expense of the not-for-profit organization. "Self-dealing," or related-party transaction violations, create the greatest risk of personal liability for directors. It is often targeted by enforcement agencies and neither Directors & Officers insurance nor the business judgment rule provide protection for trustees. The IRS can impose substantial monetary penalties for violations on officers and directors. Board policies concerning self-dealing should be clear and broadly disseminated, and full disclosure of potential conflicts must be assured. The board must be satisfied that any transaction would stand on its own absent the involvement of a board member.

These three legal responsibilities pertain to all decision-making, to every action of the board, and to all strategic planning. They hold trustees responsible and potentially personally liable for staying informed and aware – regardless of one's degree of participation, presence or absence at a meeting, or lack of opportunity to inquire, read, question or intervene.

For more practical governance resources, click on www.GreatBoards.org. or contact Bader & Associates, 12225 Seline Way, Potomac, MD 20854 301-340-0903 info@GreatBoards.org.