



Legal & Ethics

Malcolm and Cherise have really been enjoying their tenure on the board of the Association of People to Solve Community Problems. They have proven to be very active board members; they are involved in the governance of the organization, attend board meetings each month, and help to set its strategic direction. They give guidance to the organization's staff when appropriate, but allow the executive director to really take charge of implementing the direction they set.

For several months, Jin, the executive director, has been discussing how to make sure more people know about the work the Association has been doing. They have really made a difference in the community, and he believes if more people know about it, they will be more supportive of the organization. He believes it is time to hire a marketing consultant.

Malcolm has been working in marketing for the last six years. He has wanted to go into consulting, and he sees this as a good opportunity to further his own career and to help the Association he respects so much. "Tell you what", Malcolm says at the board meeting; "I will be your consultant. I will only charge you \$75 an hour. That is much cheaper than anyone else you will get."

Cherise jumps in: "Malcolm is right. That is much cheaper than anyone else. We should hire him." The board quickly votes to hire Malcolm as a marketing consultant, at \$75 an hour, with as many hours as he feels is necessary to do the job successfully.

What is a nonprofit?

The word "nonprofit" is not a legal term. It is the abbreviation of "organization bound by a non-distribution of profits constraint." This means the profits of the organization (those above and beyond the expenses) must be reinvested into the organization.

Very generally, nonprofit has come to mean a 501(c)3 organization. 501(c)3 is the area of the IRS tax code where you can find that these organizations are both charitable and tax-exempt. In addition, they can give out tax deductions to those who make donations. In Delaware, this organization must also be registered as a nonstock corporation with the Secretary of State's office.

Who owns a nonprofit?

NO ONE owns a nonprofit organization. Many executive directors or board chairs mistakenly believe it is *their* organization. The board of directors is simply operating the nonprofit in trust for the government and the community it serves. In fact, if a nonprofit dissolves and the board chooses not to send the assets of the organization to another *nonprofit* organization with a similar mission, then the government may elect to halt the transaction and to seize all the assets.

What did the board of the Association above do wrong?

Malcolm may in fact be the best person for the job. And he may be the cheapest. But the board has the responsibility to do 'due diligence' before making that decision. Nonprofits and their boards have an obligation to always do their research. If you were making a decision to hire someone to paint your house, you would get estimates, check references, and then make an informed decision. Why should an organization and its board do any less?

This process is important in any decision involving use of the organization's resources; it is even more important when a board member is involved. What happens if the local newspaper finds out that Malcolm, a member of the board, was paid \$10,000 to do a job that another expert says he could have done for \$5,000? These potentially embarrassing situations should be avoided and can be when the board is thorough and uses common sense.

Can a board member ever contract with the board he or she serves on?

Yes, he can. But this where the board performing its due diligence is absolutely essential. There is nothing inherently wrong with Malcolm getting this contract. But the board has some work to do beforehand. The board must always ask "how would this look?" and "Is this fair for the agency?"

First, the board should accept bids from others for this job. It should put out a request for proposals, and contact several marketing consultants to find out their costs. Then it should check references, view portfolios, etc. Last, the board should make an educated decision. It is possible that Malcolm, although he has no direct experience in this area, is the best option because he is both cheapest and already knows the organization. But he might be outbid; that is a risk of this process. A board member must not take advantage of opportunities that come up in the daily operations of the agency.

During this process, Malcolm should file a *conflict-of-interest* statement (see below), and should not vote on this matter. Some boards allow a board member to stay in the room or to be a part of the discussion when conflicts arise; some do not. That is a matter of board preference. What does matter is that Malcolm must never vote on any matter that will directly affect or benefit him (or friends, close family members, or coworkers) personally.

In addition, Malcolm and the board should consider whether he can effectively function as a board member while contracting with the organization. It is possible that serving as a paid consultant with an organization would be too great a conflict-of-interest for Malcolm to also serve on the board. He, the board chair and the executive director should have a discussion about this; it may end up with Malcolm resigning from the board.

What is a conflict-of-interest policy?

A conflict-of-interest policy identifies the types of conduct or transactions where the self interest of a board or staff member may be at odds with the best interests of the organization, sets forth procedures for disclosure of potential or actual conflicts, and provides for review of individual transactions by the uninvolved members of the board of directors.

Often, disclosure statements are filled out once a year by all staff and board members of an organization. This disclosure statement allows the rest of the organization to know about potential conflicts, and to keep the involved parties from having to make decisions that may either look bad (thereby heading off attacks from the press, the IRS, or any other number of entities) or that actually

are bad (and lead to loss of funding, loss of exempt status, or fines for board members). Each board member must know when to let others know that a potential conflict exists.

The new 990 (introduced in 2008) asks whether a nonprofit has a conflict of interest policy.

What is the 990?

The IRS Form 990 is the Return of the Organization Exempt from Income Tax. Basically, it is your organization's annual tax return. It is a public document, filed with the IRS. The 990 is extremely important for two reasons: 1) the IRS requires accurate information for you to maintain your tax-exempt status, and 2) it is a public document. Anyone can view the Form 990 by signing up for a free account with [GuideStar](#). Before joining the board of an organization, a potential board member will definitely want to check out the organization's 990 to make sure everything seems aboveboard.

What are the legal issues that should be considered when serving on a board?

- **Liability**

A nonprofit is just like any other corporation. As a board member, you are legally responsible for guiding the lawful actions of the organization. In the state of Delaware, as long as you are acting in the best interests of the organization, the corporation is the entity that is responsible for its action. In most cases, a board member is not personally liable for any debts or actions of the organization. The Volunteer Protection Act of 1997 grants immunity from personal liability for volunteers of nonprofit organizations. Follow sensible and prudent practices and these simple guidelines to ensure your protection.

- **Legal compliance—state and national laws**

Nonprofits must follow all state and national—and in some cases, local—laws. This includes complying with laws and regulations relating to fundraising, licensing, financial accountability, document retention and destruction, employment practices, limitations on lobbying and political advocacy, and the payment of required taxes. Before a potential board member accepts a position on a board, she should ask pointed questions of the staff or board chair. Does the nonprofit follow all these rules? Is there any bad history? Does it have policies in place for finances, human resources, conflicts of interest, etc? Does it have Directors and Officers Insurance, in case of a lawsuit?

- **Intermediate sanctions**

By its definition in section 501(c)3 of the federal tax code, a nonprofit may not benefit a particular individual; it exists to benefit the public. If a nonprofit is seen as providing some unreasonable benefit to an individual—either a board member or a staff member—then an excess benefit transaction has occurred. If the IRS finds evidence of this, they can levy intermediate sanctions against the person receiving the benefit; that is, they can ask for all the money back, and can fine him on top of that.

How can this be avoided? A board of directors should research financial decisions they make. They should compare salary and benefits of similar agencies before deciding on an executive director's salary, and should accept competitive bids before awarding contracts. They must be aware at all times of whether any transaction they make is in line with current standards in the community and industry.

- **What are the legal responsibilities of a board member?**

This is covered in a separate “Governance and Accountability” training module.

So what are a board member’s potential financial liabilities?

Over 87% of lawsuits against boards and nonprofits are related to employment issues. And the biggest issue that comes up in these lawsuits is the failure of the agency to properly pay employment taxes. Yes, nonprofits must pay employment taxes. And they must pay them on time, or the agency will be fined. In the event that a nonprofit dissolves and debts of the agency still exist, it is not likely that a board member will have a personal obligation to pay creditors. However, in this situation the Board should seek sound professional legal and financial counsel to see that an orderly wind up occurs and that employment or other taxes are properly handled. Ensuring your organization has a proper financial accounting system that pays these debts on time is crucial. Remember, as a board member, you have a right to ask whether this is happening.

What legal protection do I have as a board member?

The simplest protection comes from doing your job correctly and responsibly. If you act with your full fiduciary responsibility in mind at all times, the chances of a lawsuit or sanctions are slight. However, if the unthinkable does happen, there are several protections.

First, you are a director of a corporation. According to Delaware law, a certain amount of shielding comes from that fact, as long as you are acting in good faith. Second, an organization should have Directors and Officers Liability Insurance. D&O Insurance—as it is known—protects officers during lawsuits when the officer has acted in the best interest of the corporation; most importantly, it typically covers the costs incurred in the defense of lawsuits. Before you join a board, you should always make sure that organization has the appropriate amount of D&O Insurance to protect you and your fellow board members.

Review of the basics:

Can you now answer the following questions?

1. Can Malcolm work as a marketing consultant for the Association of People to Solve Community Problems?
2. If so, what process should the board go through to hire him?
3. When can a board member be held liable for debts of the organization?
4. Name four compliance areas potential board members should consider before joining a board.

Quick Links to More Resources about Legal & Ethics

The Nonprofit Legal Landscape, produced by [BoardSource](#) is a great resource to explain the laws that affect nonprofit organizations.

Don Kramer’s [Nonprofit Issues](#) is an excellent newsletter about the legal requirements nonprofits should be considering.

For more information on the 990, check out the IRS’ [Exempt Organizations](#) website.

The [Nonprofit Law Blog](#) is updated frequently by an attorney with years of experience in nonprofit law.

The [Delaware Association of Nonprofit Agencies](#) maintains a legal page in their InfoCentral. In addition, members of DANA can get sample policies and procedures for free.

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[Legal and Ethics Training Module Survey](#)