

**Right From The Start:
Responsibilities of Directors
of Not-for-Profit Corporations**



NEW YORK STATE OFFICE

of the

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New York State Attorney General Eric T. Schneiderman is pleased to offer this booklet to assist current and future boards of directors of New York not-for-profit corporations (and, by analogy, trustees of New York charitable trusts) to understand and carry out their fiduciary responsibilities to the organizations they serve.

Charitable organizations contribute substantially to our society. They educate our children, care for the sick, preserve our literature, art and music for us and future generations, house the homeless, protect the environment and much more. The fiduciaries of those charitable organizations are responsible for managing and preserving the charitable assets that benefit all of us.

Whatever their mission or size, all organizations should have policies and procedures established so that (1) boards understand their fiduciary responsibilities, (2) assets are managed properly and (3) the charitable purposes of the organization are carried out. A failure to meet these obligations is a breach of fiduciary duty and can result in financial and other liability for the board of directors..

Please read this booklet carefully. It contains general information concerning fiduciary oversight of charitable assets. The Attorney General publishes another booklet, *Internal Controls and Financial Accountability for Not-for-Profit Boards*, which contains more detailed information on managing a charitable organization and overseeing its assets. That booklet and other publications of interest to board members may be found at:

www.charitiesnys.com

This booklet is designed to provide guidance to fiduciaries of charitable assets. It is not a substitute for

advice from a qualified lawyer, independent public accountant or other professional.

The following guidelines are designed to assist board members in carrying out their responsibilities.

I. WHO MAY JOIN A BOARD?

Board members come from all backgrounds, bringing many different talents to the organizations they serve. Anyone over eighteen is legally qualified to serve on a board.

II. WHAT SHOULD A PROSPECTIVE BOARD MEMBER KNOW BEFORE JOINING A BOARD?

Anyone considering membership on the board of a not-for-profit corporation should do the following *before* joining:

→ Read the organization's certificate of incorporation, application for federal income tax exemption, by-laws and board and committee minutes for at least the last year to learn about its stated purposes, activities and concerns.

→ Obtain a current list of board and committee members and find out from the board chair and the organization's chief executive and financial officers what is expected of board members. Try to determine if the organization is managed by its board or its staff and, if the latter, how open is the relationship between board and staff. Talk to current and recent former board members to learn about what the board does and why any former board members recently left the board. In addition, make sure that the board and committee meetings are usually well-attended.

→ Review the organization's Internal Revenue Service Form 990 or 990 PF and audited financial statements for at least the last two (2) years as well as its current internal financial reports to see how the organization uses its assets and to evaluate its financial health. Is its auditor's report on its financial statements unqualified? Has the auditor sent the organization a management letter? Has the Internal Revenue Service recently audited the organization? What does its report say? Ensure that it is in compliance with all conditions stated in its federal income tax determination letter.

→ Find out if the organization is required to register with the Attorney General's Charities Bureau and, if so, whether it has registered and filed all required reports. Evaluate whether the filings, audit reports and other compliance requirements appear to be completed on a timely basis. Find out whether there are any tax issues or concerns, or notices received from governmental authorities. Find out what other filings might be required. If the organization has paid employees, it must file the appropriate payroll tax forms and pay the appropriate taxes. The organization may also have sales tax and unrelated business income tax responsibilities.

→ Obtain an understanding of the internal control structure of the organization and the processes in place to monitor it. Determine whether there is a current accounting policies and procedures manual that is followed. Review the past two (2) years, management letters received from the public accountants and find out what has been done to remedy any problems identified. (For further information on internal controls and accountability, please see the Attorney General's Charities Bureau booklet - *Internal Controls and Financial Accountability for Not-for-Profit Boards*. That booklet and other publications of interest to charitable fiduciaries are available at www.charitiesnys.com.

→ Understand the organization's mission, learn about its programs, read its publications, visit its program sites, look at its website and talk to key staff and major donors. Find out about its reputation in the community.

→ Review the organizational chart and understand the accountability structure of the organization. Find out the backgrounds of key management and understand the employee evaluation and compensation processes and due diligence procedures for material contracts entered into.

→ Make sure there is a conflict of interests and code of ethics policy in place and that it is updated annually.

→ Find out what committees the board has established and decide which (if any) to join. Make sure the committees appear to be sufficient (investment, budget, finance, audit, compensation, human resources, nominating, governance, etc.).

→ Determine who the organization's auditors are, what their reputation is and what their performance of the audit process has been.

→ Find out if materials to be considered by the board or its committees are distributed in advance of meetings and whether they provide sufficient information necessary to be part of the stewardship process. Find out how the meetings are structured; by consent agenda or other means.

→ Obtain the current year's budget and cash flow projections. Find out how they compare to actual income and expenses and what processes are in place to monitor these comparisons.

→ Find out whether the insurance coverage appears to be appropriate, including Directors and Officers' liability and employee fidelity insurance. The latter is particularly important - it is surprising how often embezzlement is discovered.

→ Be sure to be able to devote the time expected of a board member. Understand any responsibilities for fundraising, personal giving commitments and other functions expected of board members. Learn what training (if any) is provided to the board. Joining a board without sufficient time to devote to its business is often at the root of troubles faced by many boards. A decision to decline an invitation to join a board because the invited individual is "over-extended" should be respected.

III. WHAT ARE THE DUTIES OF BOARDS OF DIRECTORS?

While the board is not usually involved in the day-to-day activities of the organization, it is responsible for managing the organization and must make decisions crucial to the life and direction of the organization, such as adding or removing board members, hiring and firing key officers and employees, engaging auditors and other professionals and authorizing significant financial transactions and new program initiatives. In carrying out those responsibilities, members of a board of directors must fulfill fiduciary duties to the organization and the public it serves. Those primary legal duties include the duties of *care*, *loyalty* and *obedience*. If the organization has affiliates or subsidiaries, the legal duty of impartiality, the duty of fairness to all the charitable interests, may also come into play.

A. Duty of Care

The *duty of care* requires a director to be familiar with the organization's finances and activities and to participate regularly in its governance. In carrying out this duty, directors must act in "good faith" using the "degree of diligence, care and skill" which prudent people would use in similar positions and under similar circumstances. In exercising the duty of care, responsible board members should, among other things, do the following:

→ Attend all board and committee meetings and actively participate in discussions and decision-making such as setting of policies. Carefully read the material prepared for board and committee meetings prior to the meetings and note any questions they raise. Allow time to meet without senior management present.

→ Read the minutes of prior meetings and all reports provided, including financial statements and reports by employees. Make sure her or his votes against a particular proposal are completely and accurately recorded. Do not hesitate to suggest corrections, clarification and additions to the minutes or other formal documents.

→ Make sure to get copies of the minutes of any missed committee or board meeting and read them timely, suggesting any changes that may be appropriate.

→ Make sure there is a clear process for approval of major obligations such as fundraising, professional fees (including auditors), compensation arrangements and construction contracts.

→ Make sure that board minutes reflect any dissenting votes in action taken by the board or that any dissenting vote is expressed in writing by letter to the board. Such records are necessary in order for a board member to disclaim responsibility for any particular decision. Absent board members must do this promptly in writing.

→ Read any literature produced as part of the organization's programs.

→ Make sure that monthly financial charts of accounts and financial reports prepared for management are available to the board or finance and audit committees, and that they are clear and communicate proper information for stewardship. Make sure there is an ongoing actual to budget comparison with discrepancies explained.

→ Participate in risk assessment and strategic planning discussions for the future of the organization.

→ Insure that the organization has addressed the sufficiency of its written internal financial controls and written policies that safeguard, promote and protect the organization's assets and that they are updated regularly. Obtain an employees, officers and directors fidelity bond to protect the organization from embezzlement. Have a policy regarding disclosure and identification of fraud (whether or not material). Make sure a policy for records retention and whistleblower protection is in place. Create a background check policy for prospective employees.

→ Determine whether or not the organization indemnifies its officers and directors from liability and has directors' and officers' liability insurance. If it does, find out what is covered and what is not. If it does not, find out why.

→ Encourage diversity among board members. Diversity will help insure a board committed to serve the organization's mission with a range of appropriate skills and interests.

→ Be involved in the selection and periodic review of the performance of the organization's Chief Executive Officer, Chief Financial Officer and other key employees responsible for the day-to-day activities of the organization. The board is responsible for ascertaining whether these individuals have the appropriate education, skills and experience to assume a key position and then evaluating their performance.

B. Duty of Loyalty

The board should have a written "conflicts of interest" policy so that all members are aware of the type of transactions that may prohibit them from joining the board. Some such policies prohibit board members from engaging in any transaction that may result in even the appearance of a conflict of interest. They should provide for written disclosure of anticipated or actual conflicts.

Directors are charged with the duty to act in the interest of the corporation. This duty of loyalty requires that any conflict of interest, real or possible, always be disclosed in advance of joining a board and when they arise. Board members should avoid transactions in which they or their family members benefit personally. If such transactions are unavoidable, disclose them fully and completely to the board.

In order to exercise this *duty of loyalty* directors must be careful to examine transactions that involve board members or officers. The board must not approve any transaction that is not fair and reasonable, and a conflicted board member may not participate in the board vote. There should be an established code of ethics in place that is updated annually as well.

Transactions involving conflicts should be fully documented in the board's minutes, and conflicts policies and disclosure statements should be discussed with the organization's auditors and attorneys.

C. Duty of Obedience

A board has a *duty of obedience* to insure that the organization complies with applicable laws and regulations and its internal governance documents and policies, including:

- Dedicating the organization's resources to its mission.

- Insuring that the organization carries out its purposes and does not engage in unauthorized activities.

- Complying with all appropriate laws, including registering with the Attorney General's Charities Bureau in New York State, complying with registration and reporting laws and other applicable laws of all states in which it conducts activities and/or solicits contributions, filing required financial

reports with the Attorney General, the State Worker's Compensation Board, the State Department of Taxation and Finance and the Internal Revenue Service, paying all taxes such as Social Security, income tax withholding (federal, state and local) and any unrelated business income tax. Board members may be personally liable for failing to pay employees' wages and benefits and withholding taxes on employees' wages.

→ Providing copies of its applications for tax-exempt status (IRS Form 1023), federal reports (IRS forms 990, 990 PF, 990 EZ) and its financial reports filed with the Attorney General's Charities Bureau to members of the public who request them.

IV. IDENTIFY, UNDERSTAND AND UPDATE THE ORGANIZATION'S MISSION AND INTERNAL POLICIES

Nonprofit organizations are created to achieve a specific purpose or purposes, such as making grants to operating charities, setting up a soup kitchen, teaching children to read, providing health care, supporting cultural institutions, preserving the environment, assisting senior citizens or one of the many thousands of other charitable activities conducted in our state and our country. Those purposes, or the mission of the organization, are described in the organization's certificate of incorporation and/or by-laws or other constituent document.

If an organization's purposes are not already clearly stated in one of its organizational documents, one of the first activities of the board should be to draft a clear statement of the organization's mission (which should correspond to its stated purpose to the IRS) and to ensure that everyone involved with the organization, directors and officers, employees, volunteers, fundraising professionals, and other professionals, is fully familiar with and understands the mission. Those individuals plan its future, conduct its programs, raise its funds, make it known to the public, present its financial records to regulatory agencies and others and give it professional advice. Unless they fully understand why the organization was formed and what it plans to accomplish, they will not be able to perform their respective tasks appropriately. The mission should be periodically re-assessed and evaluated and amended as needed.

Employees and volunteers should be aware of the organization's internal controls that impact their area of

responsibility. At the time of adoption or revisions of internal controls, all directors, officers, employees and volunteers should be made aware of the organization's internal controls, given a copy of the policy and procedures manual, and trained to understand what is expected of them in carrying out their duties and in advising the organization's management and/or the board of directors of violations of the policy. New employees and volunteers should be trained before they assume their responsibilities.

Periodic review of an organization's structure, procedures and programs will assist board members in determining what is working well and what practices the organization might want to change in order to be more efficient, effective or responsible.

V. MONITOR FUNDRAISING CONDUCTED ON BEHALF OF THE ORGANIZATION

Many organizations contract with professionals to raise funds on their behalf. Since the fund raiser represents the organization to the public, the selection of a fund raising professional is extremely important. Establishing and following procedures for selection of a fund raising professional can avoid future problems. Such procedures should include:

- Obtaining bids from several fundraising professionals before entering into a contract. Services and fees differ, and comparing bids will aid in the selection of the best contractor for the organization.

- Checking with the Attorney General's Charities Bureau to see if the fundraising professional being considered are registered and have filed all required contracts and financial reports.

- Asking the Charities Bureau for copies of the fundraising professional's contracts with other charities to determine the services performed for and the fees charged to those charities.

- Asking the fundraising professional for references. A reputable fund raising professionals should be happy to provide a potential client with the names, addresses and telephone numbers of some of its clients.

→ Contacting some of the fundraising professional's other clients to see if those nonprofits were satisfied with the services received.

→ Finding out whether the organization's fundraising contracts contain the clauses required by Article 7-A of the Executive Law.

→ Reviewing all written solicitations and scripts used by the fund raising professional, making sure that solicitation material appropriately describes the organization and its activities, includes the name of the organization as registered with the Attorney General and advises potential contributors that they may obtain the organization's financial report from the organization itself or from the Attorney General.

→ Requiring, as mandated by New York law, that the fundraising professional and any of its representatives ("professional solicitors") disclose the name of the specific professional solicitor and the employing fundraising professional and state that the solicitor is being paid to raise funds.

VI. MAKE USE OF AVAILABLE RESOURCES

In carrying out their responsibilities, board members should realize that they need not do it alone. There are many resources available to assist not-for-profit organizations in fulfilling their fiduciary duties.

Following are some of those resources:¹

The Attorney General's Web site - <http://www.charitiesnys.com> - posts all forms and instructions for registration and annual filing with the Charities Bureau, links to other web sites that provide resources for not-for-profit boards and publications of interest to not-for-profit organizations.

If the material on the Attorney General's web site does not answer your particular question, you may make an inquiry to the Charities Bureau by phone or email.

¹ In addition to the resources listed in this booklet, many more resources are available on the Internet and in communities around the state. Inclusion of any particular entity should not be construed as an endorsement of that entity or the services it renders.

For questions about not-for-profit organizations, contact:

charities.bureau@ag.ny.gov or (212) 416-8401

For questions about fundraising professionals, contact:

charities.fundraising@ag.ny.gov or (518) 486-9797

Other Helpful Web Sites - links to other helpful web sites are posted on the Attorney General's web site

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www.charitiesnys.com