Responsibility & Liability of Nonprofit Board Members

Virginia Society of Certified Public Accountants
A free resource provided by the Virginia Society of Certified Public Accountants
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Introduction

Nonprofit organizations range from uncomplicated clubs or associations to groups with a full national or international scope. The work of nonprofit organizations is socially beneficial. As a result, social policy articulated by case law decisions and acts of legislatures have afforded certain protections for these organizations and their officers and directors. While service with these organizations can be rewarding, in today’s litigious society, officers and directors must know their responsibilities and potential exposures to litigation.

This guide includes brief discussions of the duties and liabilities of nonprofit officers and directors. This guide also provides information on various corporate structures under state law and explains how the corporate structure influences the duties and liabilities of nonprofit officers and directors.

Duties Owed by Nonprofit Officers and Directors to Their Organizations

Corporations, both for-profit and nonprofit, and unincorporated associations, are generally governed by their boards of directors. Day-to-day operations are generally managed by a small group of executive officers, typically board members elected to serve as president, vice president, secretary, and treasurer. Although statutory and common-law immunities provide protection against liability for acts of board members in the conduct of business on behalf of the organization, courts generally have held that the following duties are owed to organizations by board members:

Duty of loyalty: Directors and officers of an organization owe a duty of loyalty when making financial decisions for the organization to act on behalf of the interests of the organization and not their own personal financial interests.

- Corporate opportunity — A corporate opportunity refers to any business opportunity that may benefit a corporation. Directors and officers must not take for themselves any business opportunity that could benefit the corporation.
- Use of inside information — Confidential information cannot be used by a director for personal gain or to the detriment of the corporation or organization or its members.
- Conflicts of interest — Directors may not enter into contracts with the organization without full disclosure and approval, nor should organizations enter into contracts with past directors without disclosing such arrangements in the financial footnotes.

Duty of obedience: Directors should not exceed their delegated authority or direct the organization beyond its exempt purpose or mission as set forth by the articles, by-laws or constitution. Such actions violate the trust of those who support the organization and can jeopardize the organization’s tax-exempt status.

Duty of care: Directors and officers must act in the same manner a reasonably prudent person would to exercise reasonable care in the exercise of their responsibilities with the organization. In Virginia, with respect to directors of non-stock, nonprofit corporations, Code of Virginia statute 13.1-870 adheres to the general rule that a director will not be found liable for his actions as a director as long as he follows what is called the "good faith business judgment rule."

This rule affords directors complete protection from liability for taking actions they believe, in exercising their good faith business judgment, are in the best interests of the organization, as long as there is some rational basis for their decisions, no conflicting interest is involved and a reasonably informed decision is made. As a practical matter, this provides a subjective test. When in doubt, officers should seek approval from their entire board of directors and have the secretary document the approval process in the organization’s minutes.

The Code also provides that the director can rely upon information, opinions, reports or statements, prepared
by officers, employees, legal counsel and committees of
the board of directors, provided that the director acts in
good faith, that is, he has no knowledge that his actions
are inappropriate. This is, essentially, a gross negligence
standard.

In contrast, there is no equivalent Virginia statute specifi-
ing the standard of care owed by directors of unincorpo-
rated associations. General case law decisions are unclear
as to whether the more lenient subjective good faith stan-
dard discussed above applies, or whether a more stringent
standard of care is required. Again, the wise officer seeks
documented approval in the minutes before pursuing any
actions not clearly within the scope of the organization’s
articles and bylaws.

Liabilities of Nonprofit Officers and
Directors to Others

Contract liability: In accordance with the law of agency,
which governs corporations and unincorporated asso-
ciations, officers and directors are normally deemed to
be merely agents of the organization and therefore not
personally liable on the contracts made on behalf of the
organization. Personal liability can arise when the officer
intentionally agrees to contract liability (guaranty co-sign-
ing, intentional co-signature) or unintentionally agrees be-
cause of inadequate disclosure. An example of this might
be an officer who signs a document or debt instrument
and fails to identify herself as an officer acting on behalf
of the organization. Officers should sign contracts using
both their names and their positions (e.g., Mary K. Smith,
President of XYZ Charity).

Tort liability: Officers and directors of corporations nor-
manly are not liable for conduct of the corporation that
causes harm or injury. The rules vary with respect to unincorpo-
rated associations.

Of course, officers and directors can have personal liabil-
ity for their own conduct or criminal acts, but this liability
does not arise from the status of merely being an officer
or director. For example, conduct such as physical violence
or embezzlement could result in felony charges against a
specific officer.

Limitations of liability: Because officers and directors are
frequently named as additional defendants in litigation
arising from an act of a nonprofit organization, the Virginia
Code has specified much statutory immunity. Officers and
directors of non-stock, nonprofit corporations will have no
liability for acts of the corporation if they are uncompens-
sated. If they are compensated, liability is limited to one
year’s prior compensation.

Further, directors, trustees and officers of all organizations
exempt from taxation under §501(c) or §528 (homeowners
associations) of the U.S. Internal Revenue Code (IRC) are
provided charitable immunity. As is the case with directors
of non-stock, nonprofit corporations, directors, trustees
and officers of any such organization who act in good faith
without compensation are immune from liability in any civil
actions brought against them, while serving in their official
capacities. If compensation is received, any damages as-
essed in such actions cannot exceed the last 12 months
of their compensation.

NOTE: This charitable immunity statute does not limit li-
ability for willful misconduct or a knowing violation of the
criminal law. Further information on the Virginia standards
of conduct for directors can be found under the Code of
Virginia statute 13.1-870. Additional information on the
limitation of liability for officers and directors can be found

Federal and State Regulation Exposure

Employment and discrimination litigation: Except for
very small organizations, nonprofit organizations are also
subject to federal and state discrimination law. Certain
exemptions apply for small entities and religious organiza-
tions. Generally, plaintiffs have not been successful in
naming directors as defendants in employment litigation,
although there are some instances where liability has been
imposed. Further, Virginia law governing wrongful dis-
charge can apply to directors and officers.

Federal taxation: In general, nonprofit organizations
report their revenue to the U.S. Internal Revenue Service
(IRS) with Form 990, but they do not pay taxes on such
revenue. However, some revenue may be taxable if it is
not directly related to the nonprofit's mission. Virtually all
payrolls are taxable.

The IRC makes the “responsible person” liable for failure
to withhold and remit applicable income and payroll taxes.
While special provisions may apply to limit most liability
for outside directors, this personal liability for taxation can
result in criminal consequences for the nonprofit’s respon-
sible party. For more information on responsible persons
and the scope of liability, visit the IRS website,

State taxation: Nonprofit entities are not automatically
exempt from sales and use tax. Virginia state sales and use
tax code requires that an exemption certificate be ob-
tained by the organization, maintained and not misused.
Find out more and apply for the retail sales and use tax exemption for nonprofit organizations at the Virginia Department of Taxation (TAX) website, www.tax.virginia.gov.

**Other federal regulations:** Directors and officers may be subject to potential individual liability under additional federal statutes that include:

- Antitrust laws (government laws to regulate or break up monopolies in order to promote free competition)
- Bankruptcy
- Environmental statutes (as set forth by the Comprehensive Environmental Response, Compensation and Liability Act to control hazardous substances, pollutants and contaminants)

**Choice of Operating Entities**

The organizational structure of a business may influence the level of responsibility and liability placed upon its directors and officers. Essentially three organizational structures exist for tax-exempt organizations: non-stock corporation, unincorporated association and charitable trust.

**Non-stock corporation:** The non-stock corporation requires many statutory formalities, including articles, bylaws and board of directors resolutions. Nonprofits with this organizational structure cannot distribute any profits to members, contribute money to political campaigns or engage in lobbying activities, except in very limited circumstances. Members are not liable for corporate liability; the powers and duties of officers and directors are spelled out by the Code, and there are limitations of liability and special indemnity provisions for officers and directors. This is the safest structure for a board member. All legal documents are safeguarded by the corporation’s secretary.

**Unincorporated association:** The unincorporated association is governed by the articles of the association and/or its constitutions and/or bylaws, and requirements are not specifically spelled out by statute. Therefore, case law decisions governing officer and director responsibility and liability must be relied upon.

**Charitable trust:** Usually limited to family-trust situations for estate planning considerations, the issues of responsibility and liability of officers and directors are not usually matters of concern for charitable trusts.

**Advantages and Disadvantages of Operating Entities**

Non-stock corporation is the more prevalent form of organization for nonprofit entities and offers the advantage of statutory certainty regarding operation. For individual board members, this means greater certainty regarding their responsibilities and liabilities. In general, a judgement against a nonprofit corporation can reach only the assets of the corporation, not the personal property of its members. For the corporation as a whole, compliance with the more numerous and more complicated requirements may be a minor inconvenience compared to all the statutory benefits it receives.

**Indemnity:** Non-stock corporate directors have the benefit of a specific statute providing for mandatory and permissive indemnity (and provisions where it cannot be provided). No statute exists for unincorporated associations, but the association, by its articles, can provide for indemnity. Indemnification of a director generally will be limited to reasonable costs incurred in a legal proceeding.

**Insurance:** Non-stock corporations are permitted to provide Directors’ and Officers’ Insurance (D&O) by statute. Unincorporated associations may provide liability insurance if directed by their operational documents. A board member not covered by a D&O policy should request such coverage or buy a personal umbrella policy. Volunteers should be very cautious in serving without insurance.

**NOTE:** The cost of defending any legal action may be significant. Insurance may be the only resource available to the organization to pay indemnified legal costs.

**Conclusion — Avoiding Exposure**

Officers and directors of nonprofit organizations continue to be named as defendants in lawsuits for acts of their organizations. Although immunities have been provided by statute, officers and directors are encouraged to pay special attention to the authority granted them by the organization and not deviate from it without the permission required by the organization’s operating documents.

Under general agency law, officers and directors owe a duty of loyalty to the organization and must refrain from self-dealing, conflicts of interest and receipt of corporate opportunities without consent.

Directors are required to exercise good business judgment and always operate in good faith. Directors are encouraged to use best efforts to attend all meetings, familiarize themselves with the operating documents to determine the scope of their authority and make notation at meetings of any position with which they disagree. At the same time, directors should avoid the pitfalls of exceeding organization authority, ignoring formalities and self-dealing by themselves or any others on the board.

Many issues can be discussed freely and at length in committee meetings. Board meetings, however, are best served by very short discussions, with conflicts tabled for
future discussions in appropriate committees.

With these general notions in mind, service as a board member or officer for a nonprofit charitable entity can be most rewarding, both for the board member and the community the organization serves.

For additional information, contact the American Bar Association (ABA) at www.abanet.org or the Virginia Society of CPAs (VSCPA) at www.vscpa.com.