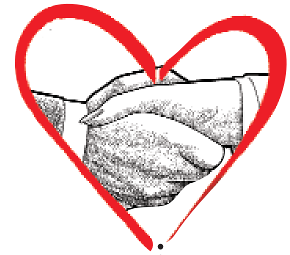
Module 3
Legal Responsibilities and Risk Management



Responsibilities of Boards and Board Members

The following information applies to for-profit and nonprofit boards. A board of directors is a group of people legally charged with the responsibility to govern an organization. Legal and fiduciary responsibilities go hand-in-hand with service on public and private boards. Service on a public or private board requires the board member to uphold the public trust.

In a for-profit corporation, the board of directors is responsible to the stockholders. The board of a nonprofit organization is responsible to the stakeholders and constituents. This principle is manifested in service to members of a particular geographic area, community, interest group, or public that the nonprofit organization serves in accordance with its mission.

An Obligation to Uphold the Public Trust

For-Profit Organizations have stockholders.

Nonprofit Organizations have stakeholders.

Nonprofit Organizations are Corporations

A corporation is a legal entity. Nonprofit organizations with 501(C)(3) status are corporations. It enables a group of people to combine their energy, time, and financial resources for nonprofit activities. In order to become recognized as a legal entity, it must conform to and be in compliance with state statutes regarding incorporation and the legal attributes associated with incorporation. The corporation has unique legal identity apart from the officers and members, managers, owners, and operators. The nonprofit corporation may enter into contracts, incur debts, earn income, and pay taxes (Mancuso, 2000:1.2).

This means they are legal entities distinct from the individuals who founded them. Boards of directors cannot delegate legal and ethical responsibilities to parties external to the board. They govern nonprofit corporations in a way similar that boards of directors govern profit corporations. The directors, employees, and members have the benefit of limited liability. The corporation is subject to litigation, legal claims, and lawsuits (Mancuso, 2000: 1.2).

Under well-established principles of nonprofit corporation law, a board member must meet certain standards of conduct and attention in carrying out his or her responsibilities to the organization. Several states have statutes adopting some variation of these duties that would be used in court to determine whether a board member acted improperly. These standards are referred to as the Duty of Care, the Duty of Loyalty, and the Duty of Obedience. Each of these standards addresses the legal and financial aspect of service on a nonprofit board (BoardSource, 2002).

<u>Duties of Board Members</u>

Duty of Care
Duty of Loyalty
Duty of Obedience

Duties of NonProfit Board Members

Duty of Care — The duty of care describes the level of competence that is expected of a board member. It is commonly expressed as the duty of "care that an ordinary, prudent person would exercise in a like position and under similar circumstances." Board members must exercise due care and stewardship in all dealings with the organization and its interest. This includes careful oversight of financial matters and reading of minutes, attention to issues that are of concern to the organization and raising questions whenever there is something that seems unclear or questionable (Hughes, 2002).

> **Duty of Care**
> This refers to the exercise of prudent care, attention, and stewardship with regard to legal and fiduciary matters.

Duty of Loyalty — The duty of loyalty is a standard of faithfulness. Conflicts of interest, including the appearance of conflicts of interest, must be avoided. This includes personal conflicts of interest or conflicts with other organizations with which a board member is connected. Board members can never use information obtained as a member for personal gain. The best interests of the organization must be upheld.

> **Duty of Loyalty**
> This refers to faithfulness and avoidance of any conflict of interest for personal benefit.

Duty of Obedience — Obedience to the organization's central purposes must guide all decisions. The board members must also ensure that the organization functions within the law, both the "law of the land" and its own bylaws and other policies. The duty of obedience requires that board members be faithful to the organization's mission. They are not permitted to act in a way that is inconsistent with the central goals of the organization or legal statutes. A basis for this rule lies in the public's trust that the organization will manage funds to fulfill the organization's mission (Hughes, 2002).

> **Duty of Obedience**
> Uphold the laws and policies in conformity with the organization's mission and in compliance with legal statute.

Legal Responsibilities and Duties of Boards

Legal Responsibility

The legal duty of a board member is to act as a voting member of the board with full authority and responsibility to develop policies, procedures and regulations for the operation of the organization; to monitor the organization's financial health, programs and overall performance; and to provide the chief executive officer with the resources to meet the needs of those the organization serves.

In order to gain a tax exemption for charitable reasons, a nonprofit organization must qualify under the Federal Tax Code as a charitable organization. The organization is a nonprofit corporation for a Section 501© (3) religious, educational, charitable, scientific or literary purpose that will qualify for 501 © (3) public charity status (Mancuso, 2000, 8.2).

You may call your local or regional IRS forms request telephone or the national toll-free number, 1-800-TAX-FORM (1-800-829-3676) or go on-line to http://www.irs.gov or pick up the forms in person at your local IRS office (Mancuso, 2000: 8.2-3).

- IRS Publication 557 — Tax-Exempt Status for Your Organization (Rev. November 1999)
- IRS Publication 578 — Tax Information for Private Foundations and Foundation Managers

Nonprofit organizations are chartered and registered at the state level with the office of the Secretary of State. These organizations provide continuity and standardization for the organization by setting up a corporation or legal existence. This enables the organization to represent its point of view through the interpretation and distribution of its products and services. The organization may take on an advocacy role for the benefit of a mission-specified clientele.

The board is responsible for ensuring that the organization meets legal requirements and that it operates in accordance with its mission and for the purpose for which it was granted tax-exemption. Individual board members must exercise the Duty of Care - meaning they must attend meetings, be prepared to make informed decisions by reading the information provided and requesting additional information if necessary, and carry out their duties in a reasonable and responsible manner. As stewards of a public trust, board members are responsible for protecting the organization's assets (BoardSource, 2002).

The board also has legal responsibilities regarding the hiring of employees in compliance with federal and state law. Equal Employment Opportunity policies, The Americans with Disabilities Act, and other compliance issues regarding local fire codes, law enforcement must be addressed (Di Lima and Johns, 1996: 3.13-19).

- Determine the organization's mission and purpose. A statement of mission and purpose should articulate the organization's goals, means, and primary constituents served. It is the board of directors' responsibility to create the mission statement and review it periodically for accuracy and validity. Each individual board member should fully understand and support it.

- Maintain accountability and ensure legal and ethical integrity. Except in the direst of circumstances, the board must serve as a court of appeal in personnel matters. Solid personnel policies, grievance procedures, and a clear delegation to the chief executive of hiring and managing employees will reduce the risk of conflict. Provide sustainability and continuity for the organization by setting up a corporation or legal existence to manage risk. Account to the public for the products and services of the organization and expenditures of its funds, including: (1) provide for fiscal accountability, (2) approve the budget, (3) formulate policies related to contracts from public or private resources and (4) accept responsibility for all conditions and policies attached to new, innovative, or experimental programs (McNamara, 1999).

Fiduciary Responsibility

They must account to the public and interested parties for the products and services of the organization and expenditures of its funds. This includes (1) provide for fiscal accountability, approve the budget, and formulate policies related to contracts from public or private resources (2) Accept legal responsibility for all conditions and policies attached to new, innovative, or experimental programs (McNamara, 1999; Hanlon 1997).

- Practice fiduciary responsibility and manage resources effectively. The board, in order to remain accountable to its donors, the public, and to safeguard its tax-exempt status, must assist in developing the annual budget and ensuring that proper financial controls are in place. Acquire sufficient resources for the organization's operations. The board must finance the products and services in accordance with policies.

Financial Management and Sustainability

Board members are "trustees" of their organization who approve an annual budget that ensures it can meet its financial needs. In addition, board members monitor the overall financial health of their organization by reviewing annual reports of an auditor recommended by the administrator. This, however, does not mean that they should interfere with the administrator's responsibility to make day-to-day operational expenditures. As part of their fiduciary responsibility, many board members are actively involved in making sure that the organization has the money it needs. This may include making a personal contribution; serving as an advocate with a foundation, corporation, or government entity; organizing a fund-raising event or hosting a benefit; or face-to-face solicitation of other individuals. Ensure that sufficient resources for the organization's operations as made available. The board also ensures that budgets are planned, proposed, and followed so that adequate financial resources exist to produce organizational products and services to clientele and constituents.

Fundraising must have a purpose. The board must become actively engaged in fundraising for new products as well as continuing programs and activities. The board and a committee of the board must always keep the mission of the organization in mind when pursuing external funding. All fundraising goals must be tied to the core mission and values of the nonprofit organization. The board must ensure that project proposals are presented in written form to include project goals, objectives, methods, and budget. No fundraising effort will succeed if potential donors cannot share in the vision set forth by the organization (Di Lima and Johns, 1996: 2.1).

- Ensure access to adequate resources. One of the board's foremost responsibilities is to provide adequate resources for the organization to fulfill its mission. The board should work in partnership with the executive director and staff to raise funds from the community (BoardSource, 2002).

Policy Formation and Planning

Management, Oversight, Planning and Policy Formation

The Board governs the organization and guards against litigation and mismanagement by instituting and implementing appropriate broad policies and objectives in keeping with the organizational mission. Fulfilling the objectives in compliance with legal requirements and established policies goes far to protect the organization and its constituents from harm. The policies and objectives, agreed to by the administrator and staff, reduce the likelihood that organization will suffer losses through negligence. This is accomplished by self-assessment and thorough evaluation of practices and programs.

Organizational Management

The board is responsible for ensuring that the organization is well run from an oversight perspective. The administrator is responsible for daily operations and management. The board moderates the power of management and has the power to hire and remove the chief executive, usually called the executive director or president. The management and oversight function entails assurance that meeting proceedings are reported and recorded accurately, organizational records are complete and subject to review by board members, and that meeting minutes reflect board action and policy accurately. Board members must ensure that the organization's mission is realistic statement and followed. The board ensures that the chain of command is followed.

Board members set broad policies and goals, and give the administrator free rein to implement them in the day-to-day management of the organization. Individual members of the board, however, have no authority to act independently of the full board. When they do, it can seriously damage the organization's ability to carry out its mission, board team spirit and the organization's image in the community. Board members who abuse their position this way should be disciplined or censured.

Individual board members should attend all board meetings and actively participate in them, and serve on committees or as board officers. Finally, board members have the responsibility to know and fulfill their proper role as board members and to act in the best interests of those their organization serves.

The board delegates the implementation of policy to the administrator (executive director). Select and appoint an executive director to whom responsibility for the administration of the organization is delegated. This includes reviewing and evaluating the administrator's performance regularly on the basis of a specific job description. It also includes the administrator's relations with the board, staff, volunteers, and stakeholders. The administrator shall provide leadership to the organization, program planning, policy matters, and implementation strategies. The board ensures that the administrator manages the organization effectively by offering guidance through policies. The board ensures that communication follows appropriate channels. The board determines the administrator's term of service to the organization.

- Ensure effective organizational, policy, and program planning. As stewards of an organization, boards must actively participate with the staff in an overall planning process and assist in implementing the plan's goals.
- Select the administrator (executive director). Boards must reach consensus on the chief executive's job description and undertake a careful search process to find the most qualified individual for the position. Select and appoint a chief executive to whom responsibility for the administration of the organization is delegated.
- Support the administrator (executive director). The board should ensure that the executive or administrator has the moral and professional support he or she needs to further the goals of the organization. Board members must develop a constructive relationship with the executive based on contracted, written job descriptions and prescribed duties. The board normally sets policy and the executive carries out the policies. The board and executive comprise the organization's leadership team.
- Recruit and orient new board members. The board must develop an organizational structure tied to stakeholders, constituents, volunteers, and community interests. These ties should attract people and encourage full participation at all levels of the organization and the community of interests (BoardSource, 2002; McNamara, 1999; Ingram, 1999).

Program and Service Delivery

Stakeholder and Constituent Representation

The board has an obligation to ensure that the organization fulfills its mission as a nonprofit organization. Through the delivery of programs and services the board meets the needs of designated clientele and constituents. Often, board members are chosen so that they can bring to the board the experience or perspective of a particular group or segment of the organization's constituency. Boards provide groups and communities that a nonprofit serves to have a voice in its governance. However, representing a constituency or a personal viewpoint must take a back seat when voting. All board members are expected to vote with the nonprofit organization and the public's best interest in mind. Board members must be accountable to the stakeholders, constituents, and the public (BoardSource, 2002).

- Determine, monitor, and strengthen the organization's programs and services. The board's role in this area is to determine which programs are the most consistent with an organization's mission, and to monitor their effectiveness. Provide continuity for the organization and represent the organization's point of view through interpretation of its products and services. Board members become advocates for the organization. They govern the organization by broad policies and objectives, formulated and agreed upon by the executive and possibly the staff. This includes assigning priorities and ensuring the organization's capacity to carry out programs by continually reviewing its work.
- Enhance the organization's public standing and public relations. An organization's primary link to the community, including constituents, the public, and the media, is the board. Clearly articulating the organization's mission, accomplishments, and goals to the public, as well as garnering support from important members of the community, are important elements of a comprehensive public relations strategy (BoardSource, 2002).

Evaluation and Assessment

Evaluate the Administrator and Programs

The board must establish prescribed methods of systematically evaluating and assessing the administration, staff, volunteers, and program delivery. Such evaluations and self-assessments should occur at least once a year. The administrator is usually an employee who is selected and evaluated by the board on a time schedule. This evaluation is a means of providing constructive feedback on a regular basis to improve performance of the administrator or executive director. Evaluation and self-assessment also applies to the functional areas of the organization including financial management, marketing plan, fundraising, programming, client services, collaboration, outreach, and program innovation. Board evaluation is an important part of evaluation also.

- Assess and evaluate board performance. By evaluating its performance in fulfilling its responsibilities, the board can recognize its achievements and reach consensus on which areas need to be improved. Discussing the results of a self-assessment at a retreat can assist in developing a long-range plan.
- Assess and evaluate the administrator's (executive director) performance. The board must assess and evaluate the executive director or administrator's performance. It ensures that the administrator has the managerial and professional support he or she needs to further the goals and mission of the organization. The administrator, in partnership with the entire board, should decide upon a periodic evaluation of the administrator's performance. The board, on a planned schedule, reviews and evaluates the executive's performance on the basis of the executive's job description. Elements of the job description should include executive-board relations, leadership in program planning, management, and implementation, and in financial and organizational management (BoardSource, 2002).

Five Basic Responsibilities of Nonprofit Boards

An Overview

Legal Responsibilities

1. Determine the organization’s mission and purpose.
2. Maintain accountability and ensure legal and ethical integrity.

Fiduciary Responsibilities

3. Practice fiduciary responsibility and manage resources effectively.
4. Ensure access to adequate resources.

Policy Formation and Planning

5. Ensure effective organizational, policy, and program planning.
6. Provide procedures for organization oversight and management.
7. Select the administrator (executive director).
8. Support the administrator (executive director).
9. Recruit and orient new board members

Program and Service Delivery

10. Determine, monitor, and strengthen the organization’s programs and services.
11. Enhance the organization’s public standing and public relations.
12. Deal effectively with stakeholders and constituents.

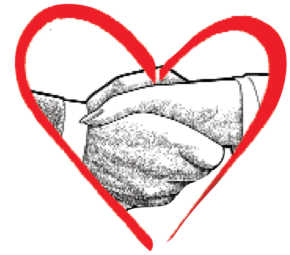
Evaluation and Assessment

13. Assess and evaluate board performance.
14. Assess and evaluate the executive director or administrator’s performance.

(BoardSource, 2002; McNamara, 1999; Ingram, 1999).

Principles of Ethical Behavior

1. Public Service is a public trust.
2. Members shall not hold financial interests that conflict with board duties.
3. Members shall not engage in financial transactions using confidential information to further any private interests.
4. Members shall not solicit or accept any gift of monetary values for conduct as a Board member.
5. Members shall not use their membership on the board for private gain.
6. Members shall act impartially and not give preferential treatment to any individual or corporate entity.



7. Members shall disclose any fraud, waste, abuse, or corruption to the proper authorities.
8. Members shall satisfy in good faith their obligations as board members, including just financial obligations.
9. Members shall adhere to all laws and regulations that provide equal opportunity to all individuals.
10. Members shall avoid any actions creating the appearance that they are violating any law or ethical standards (BoardSource, 2002).

Board Members' Legal Responsibilities as Board Members

Prepare for and Attend Meetings

- Attend all board meetings and activities including special events and board retreats.
- Come to board meetings prepared and informed about issues on the agenda.
- Board members must attend meetings and give proper attention to board business and the organization's purpose.
- Absence from a board meeting does not release the member (director) from responsibility for decisions made by the board. A pattern of absence may indeed be presumed to increase an individual's liability because he or she cannot demonstrate a serious dedication to the obligations of the position.

Contribute Information

- Contribute to meetings by expressing your point of view.
- Consider other points of view, make constructive suggestions and help the board make decisions that benefit organization's clientele and constituents.
- Keep the administrator informed about any concerns the community has.

Serve on Committees and in Offices

- Make a serious commitment to participate actively in committee work and serve on at least one committee.
- Assume board leadership roles when asked.

Learn the Organization and Its Members

- Become knowledgeable about all aspects of the organization.
- Volunteer for and willingly accept assignments and completes them thoroughly and on time.
- Stay informed about committee matters, prepare themselves well for meetings, and reviews and comments on minutes and reports.
- Get to know other committee members and build a collegial working relationship that contributes to consensus.

Public Relations

- Represent organization to individuals, the public and other organizations.
- Become an active participant in the committee's annual evaluation and planning efforts.

Finances and Evaluation

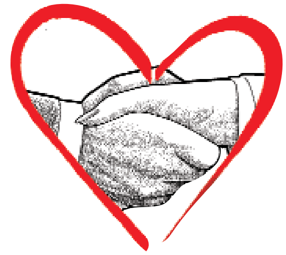
- Support the organization through a personal financial contribution. This applies only to boards of private, nonprofit organizations.
- Participate in fundraising for the organization

(BoardSource, 2002).

Key Considerations for Board Members' Legal Protection

Board Members and nonprofit organizations should consider these recommendations for self and organizational protection.

- Board members must make certain the organization is operating within a legal framework.
- There is no absolute protection against someone bringing suit against you. Conscientious performance is the standard. The best defense is a good offense: strive hard to do everything right and be able to show that you tried hard, then you are much more likely to be on solid legal ground.
- Remember that the assumption in the law is not necessarily that you must make the correct decision, but that you must make the decision correctly. It helps greatly to be able to show that the board seriously considered an action before the action was taken. Board minutes should reflect this. Board members are more at risk for taking no action than for taking the wrong action for the right reasons.
- As a board member, you are legally responsible for your decisions. Accuracy of information provided to you and the integrity of sources must be weighed in your decision-making. You must use reasonable judgment. If you have special expertise, your level of reasonable judgment can be raised to a higher standard. If something smells fishy, it probably is fishy. Engage in troubleshooting immediately and do it first-hand.
- Maintain comprehensive and up-to-date personnel policies that are reviewed by a professional, authorized by the board and well understood by management. If a manager's actions are not in accordance with a policy, courts will usually assume the manager's acts to be the official stance of the organization and to have superseded the policies.
- Schedule a presentation with a representative of your state Association of Nonprofit Organizations (i.e., SCANPO in South Carolina) to discuss in depth board liability matters and concerns. The discussion should include explanations of general liability, professional liability, workers compensation, asset



protection, and directors and officers (D&O) insurance. If you purchase directors and officers (D&O) insurance, be sure the policy covers employee suits against the organization and the legal costs of defense in court cases.

- Review financial statements and insist on understanding them. Most boards probably should have two levels of reporting. One level should be a simplified form for monthly reports to the rest of the board supplying data that has been reviewed by the finance committee and another level that contains in-depth detail for a sophisticated finance committee.

Develop a Board Member "Agreement"
What Are the Key Ingredients?

Board membership is a public trust
and a responsibility to be taken seriously.

Policies and Documentation Database Checklist

1. **Statutory**

______ Articles of Incorporation

______ Form 1023: Nonprofit Application 501(c)(3)

2. **Organization**

______ Constitution and By-Laws

______ Operations Policy Manual

______ Employment Policy and Job Descriptions

______ Contracts and Memoranda of Agreement

______ Operations Manual

______ Organizational Chart

______ Board Officers and Members

______ Annual Reports

______ Meeting Minutes

______ Committee Reports

3. **Programming**

______ Plans: Strategic, Financial, Business, Marketing, Programs, Fundraising

______ Strategic Plan Amendments / Approvals

______ Publications, Brochures, and News releases

______ Technical Reports and Fact Sheets (Handouts)

______ Evaluation: Goals, Benchmarks, and Measurement of Outcomes

______ Applications (Recruitment/Solicitations)

______ Release Forms (liability)

4. **Financial**

______ Budget Reports

______ Proposed Budgets

______ Financial Flow Chart

______ Monthly Treasurer's Report

______ Operating Budget and Revisions

______ Contracts and Insurance

______ Tax Record

Common Risks Facing Nonprofit Organizations

Defining Risk

Risk is any uncertainty about a future event that threatens your organization's ability to accomplish its mission. Viable threats endanger your organization's core assets and thereby limit your ability to provide critical services. Although your "fund balance" may be minimal, and equipment may be second generation, your agency has vital assets at risk.

To prevail, a party alleging negligence must prove that:

1. A Duty Exists — An organization cannot be found negligent unless it first had a duty to exercise care.
2. The Duty Is Breached — An organization that does not meet its duty of care may be found negligent.
3. An Injury Occurred — Negligence will not be found unless someone is hurt or something is damaged.
4. The Breach of Duty Caused the Injury — In order for an organization to be found negligent, the injury must be tied directly to the entity's breach of its duty of care.

If all four elements exist in a given situation, a court may hold the organization liable for injury or damages. One of the greatest risks facing a nonprofit is the failure to provide the requisite level of care required under the circumstances. The required standard of care, however, varies with the situation, the people involved, and the community in which the incident takes place. Nonprofit organizations serving children or other vulnerable populations must exercise a higher level of care than if the agency works with animals or the environment. Many safeguards must be observed with minors.

Categories of Nonprofit Organization Assets

1. People — Board members, volunteers, employees, clients, donors, and the public.
2. Property — Buildings, facilities, equipment, materials, copyrights, and trade marks.
3. Income — Earned income, grants, and contributions.
4. Goodwill — Reputation, stature in the community, and the ability to raise funds and appeal to prospective volunteers.

People

- The Board must protect clients, staff, volunteers, and the public from harm.
- The Board ensures that resources are available to compensate individuals harmed by the organization's activities.

An organization can evaluate the risks facing it by the magnitude of the threat to its core assets. The likelihood and potential consequences of a risk materializing determine whether it is a high priority risk requiring immediate attention. The risks most common to nonprofit organizations include:

Injuries to Clients, Employees, Volunteers and the Public

The nonprofit organization's major risk or exposure is the possibility of someone getting hurt. The injury may be the result of the organization's negligence or a non-fault accident. Every nonprofit, when serving clients or raising funds for its programs, must exercise a level of care necessary to protect people from harm. Injuries may arise from an automobile accident, workplace hazards, client participation in a regular program, or the sponsorship of a special event.

Nonprofit managers must understand the important concepts of liability and negligence to assess and prioritize risks. An organization is liable when it is financially responsible for its actions or failure to act. Claims made against nonprofit organizations frequently allege negligence, or the failure to act as a reasonable person would under similar circumstances.

Employment Practices

Data supplied by several insurers indicates that employment-related matters represent the largest share of claims filed against nonprofit under directors' and officers' liability policies. Coregis, a large insurer of nonprofit D&O coverage, reports that employment-related allegations account for more than 75 percent of nonprofit claims. The Nonprofit' Insurance Alliance of California (NIAC) reports that lawsuits alleging wrongful termination represent 60 percent of all suits filed against nonprofit boards. Charges of sexual harassment and discrimination are the next leading causes of employment practices claims. Nonprofit managers and boards must carefully establish and follow employment policies and procedures to reduce the risk of employment practices claims.

Employment risks arise from the existence of extensive laws regulating the employer-employee relationship. The laws apply to all aspects of the employment relationship — including the hiring, supervision, and termination of employees. Non-compliance can result in an employment claim and significant fees, fines or settlements.

The laws and regulations include federal, state and local requirements. Some of the issues addressed by the laws are sexual harassment, discrimination (based on sex, age, race, color, creed, national origin, disabilities, sexual orientation), wage and hour, fair labor standards, and benefit plans administration.

State nonprofit associations (i.e., SCANPO) often have model employee handbook literature for nonprofit organizations that provide guidance and information about job requirements, employee rights, fringe benefits, personnel matters, organizational management practices, policies, and operations of the organization. SCANPO distributes on request a policies manual and handbook.

The board of a nonprofit can contribute significantly to managing risk by paying close attention to hot spots -- the areas most likely to result in claims. By adopting practices that minimize the likelihood of such claims, the board places an organization on the right footing.

Property

Damage to Property

Many nonprofit organizations own property even if it is antiquated office furniture or computers. The damage or destruction of the organization's property can impair its ability to continue operations. A fire, tornado, flood, wind, explosion, vandalism, theft or electrical malfunctions can cause damage to the organization's property. The need to abandon or temporarily vacate unusable offices can severely disrupt the operations of most nonprofit organizations. The organization could face substantial costs to relocate to temporary or new offices. A property loss has both operational and financial consequences.

An organization's property can be more than its office furniture and equipment. Many nonprofit own automobiles, mobile equipment (cellular phones, two-way radios, tools), boats, and lawn or maintenance equipment. What would the impact of a major property loss be on your organization?

Many nonprofit organizations do not consider the risk of damage to property that it has borrowed or rented. Most property rental agreements assign responsibility for damage to the property to the lessee (the organization). Even if you borrow equipment without a contract, the owner may expect restitution if your organization lost or damaged the property.

A word of caution: many organizations assume that a general liability policy will cover damage to another's property. However, most general liability policies exclude damage to property owned by or in the care, custody, and control of the insured.

Income and Assets

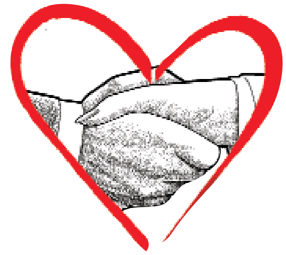
- The board must put policies in place that protect the nonprofit organization's assets and guard against potential risks. The board shall establish long-term goals and short-term objectives for the organization's program initiatives and resources.
- The board must approve an action plan to meet the organization's goals and objectives that incorporates risk management and safeguards against litigation.
- The board must ensure the availability and proper use of funds to support administrative and program activities through active participation in fund raising programs and the development and monitoring of financial management and fund-raising policies.

Fraud

Every nonprofit is vulnerable to fraud. The theft or misappropriation of funds can have severe consequences. A single major theft of funds or equipment could jeopardize seriously a nonprofit's viability and public image. The organization may suffer a cash flow crunch, loss of donor confidence, reduction in services and a loss of jobs. The public reporting of a loss could be devastating as media reports affect donations, the availability of volunteers and public goodwill.

According to Robert Hailstone at Australia's Criminal Justice Commission, the true costs of workplace crime in Australia totaled $10 billion in 1996. Hailstone also reports that fraud accounts for two-thirds of all crime. A study estimated the 1996 U.S. cost of workplace crime at $300 billion. The lack of effective internal controls may enable the thief to be successful. Even a small nonprofit with very limited resources could lose it all if an employee or volunteer steals or squanders its money. It is recommended that all officers and board member become bonded to guard the organization against dishonesty and fraudulent behavior.

CASE STUDY EXERCISE
Find the Negligence



Good Will and Public Trust

Legal Requirements

Nonprofit organizations, as holders of the public's trust, are subject to specific laws and regulations. Organizations must meet IRS requirements to maintain their tax-exempt status. The Internal Revenue Code addresses the organization's charitable mission, political and lobbying activities and proper accounting of income and expenses. Violations can lead to fines, loss of tax-exempt status or possible dissolution. Besides the IRS, every state has charitable solicitation and other laws applicable to nonprofit organizations (BoardSource, 2002).

In addition to laws regulating the operation of nonprofit organizations, many organizations must follow operational rules and regulations. Medical clinics must follow hazardous waste handling procedures and meet state requirements for a medical facility. Organizations serving children must report suspected cases of child abuse and follow other health and safety regulations. If an organization fails to comply with these regulations, the regulatory authority may impose a fine, suspend its operating license or permanently close the operation. If the media reports the incident, the adverse publicity could also affect the organization's ability to function.

To manage the risks of legal compliance, every organization must research and keep current on the rules, regulations and statutes that apply to its operations. Noncompliance can both initiate governmental action and create the basis for a liability action against the organization (BoardSource, 2002; The Alliance, 2002).

The Board's Role in Managing Risk

The primary responsibility of a nonprofit board of directors is to guide the organization in accomplishing its mission. In fulfilling this obligation, the board has a legal duty to use the organization's assets prudently. The assets of a nonprofit vary, but generally fall within one of the following categories: people (board members, volunteers, employees, clients, donors, and the public), property (buildings, facilities, equipment, materials, copyrights, and trademarks), income (sales, grants, and contributions), and goodwill (reputation, stature in the community, and the ability to raise funds and appeal to prospective volunteers). The board's oversight role empowers it to exercise tremendous influence in ensuring that the organization protects and uses its core assets solely to further the goals of the organization.

To discharge its important responsibility for insuring the health of a nonprofit, an effective board provides leadership and direction for an agency's overall risk management program. The board should pay close attention to the risks inherent in its governance activities.

Through the board's failure to act or mistakes, the directors may expose the organization's assets to losses and thus prevent the agency from achieving its mission. When the board takes the lead in protecting the organization's assets, it supports the organization's successful operation. A successful organization helps to ensure the agency's positive impact on the community for many years to come.

Following an unfavorable story in the press about an episode "mismanagement" by a nonprofit organization, the same question is always posed. Why didn't the board do something? Yet, during financial crisis, the boards of the United Way of America, Covenant House and others did not do any less than what most nonprofit boards do. The cruel reality is that some nonprofit boards are ineffective in their governing function. Only when gross mismanagement occurs does a failure at governance come to the fore (The Alliance, 2002).

The overlooked reason is that the prevailing "team" model for the relationship between boards of directors and their staff is only half of the story. "Team" members are understood to bring different skills and play different roles to support and build the organization, working toward common goals. Although board members should and do act as supporters and builders, they have another role to play as questioners and monitors of the organization. As part of the team, the board stands with their well-intentioned organization as it operates in a demanding world. In contrast, in their governing role, the board must stand outside the organization and hold it accountable to the public interest (The Alliance, 2002).

Both these roles — supporting and governing — are critical to effective work by nonprofit organizations. Rather than try to eliminate the contradictions and tensions of their governance role, boards must find techniques for strengthening their independence and creatively using this tension for the good of the organization and the purpose it was created to serve (The Alliance, 2002).

The Role of Effective Board Governance in Organizational Sustainability

The two roles of support and governance encompass different tasks. In the role of supporters, board members strive to ensure the success of the organization. Boards raise money and bring contacts and clout to the organization. Select board members may provide special legal and financial skills while all board members function as ambassadors to the community and constituents. The many books, articles and seminars on the subject testify to the emphasis on helping boards help — on strengthening organizations by means of board assistance.

The governance role, on the other hand, has as its goal protection of the public interest. Governance responsibilities for boards include selecting the top administrator and assessing his or her performance, reviewing and authorizing plans and commitments, ensuring compliance with legal and contract requirements, and evaluating the organization's work.

Both of these board roles are distinguished from that of management, the province of the administrator (The Alliance, 2002).

Suggested practices are outlined below:

- Carefully select the administrator (executive director). The board should make the delegation of responsibility for day-to-day management with care. This care begins with the thoughtful selection of the administrator (executive director). The board's ability to fulfill its legal duties and risk management responsibilities will largely depend upon the competence, skills, and cooperation of the administrator.

- In recognition of a range of liability concerns, the board should receive legal advice about recruiting and hiring a chief executive. In addition, if the board decides to negotiate an employment contract with its new administrator (executive director), the parties to the contract, the board and the administrator, should both seek counsel.

- Oversee employment practices. While the board's responsibility for hiring generally ends in the selection of the executive director, its overall responsibility for the employment practices of the nonprofit extend a great deal further. Employment-related actions are the largest source of claims filed against boards of directors under Directors' and Officers' (D&O) insurance policies (The Alliance, 2002).

The board's role is not to micro-manage every action taken by the executive director. Instead, the board is acting appropriately and responsibly when it questions whether the agency applies its employment practices consistently and uniformly. The board should also determine if the organization is following the board established employment policies. In addition, members of the board should ask what steps the staff are taking to prevent unlawful discrimination or other actions that could result in agency liability (for example, training of supervisory staff). Lastly, when the directors deem it necessary, they should direct the senior staff to strengthen or revisit such practices.

Oversee financial management and fund-raising policies. Nonprofit boards are often described as "fiduciaries" entrusted by the public with charitable funds. Few nonprofit organization board members are financial experts in the area of nonprofit and voluntary organizations. It is not necessary for all prospective board members to have highly specialized financial management skills.

To discharge their fiduciary duties and the duty of care, board members must be committed and diligent in reviewing information related to the organization's financial position. After establishing goals and objectives and approving the strategic plan, the board should approve an annual budget. The board meets its financial management responsibility by reviewing financial statements regularly and questioning whether expenditures are consistent with the program priorities and operating policies established by the board. Is the organization on a sound financial footing? Are the staff's revenue projections realistic? Do the financial statements present a clear picture of the financial condition of the agency?

Fund-raising is one area in which nonprofit boards are most active at the operational level. Nonprofit board members' ability to raise funds or access potential donors is often considered in their selection. The board's role in managing fundraising and development-related risks includes developing policy for fundraising strategy and practices. For example, does the nonprofit organization reject unsuitable gifts? Does it have procedures in place to account for the "strings" attached to certain donations? Are policies and controls in place to ensure that funds will be spent according to the provisions of restricted grants?

Liability Insurance Coverage

Directors' and Officers' (D&O) Insurance

Ensure that the nonprofit organization has Directors' and Officers' (D&O) liability insurance. Review the level of coverage. D&O policies have evolved considerably over time to meet the needs of nonprofit organizations. While some nonprofit continue to purchase traditional corporate D&O policies, most organizations select policies that respond to the unique exposures facing nonprofit organizations. Board members should be knowledgeable about the agency's D&O coverage and request information that will enable them to evaluate whether the coverage purchased by the organization is appropriate and responsive to the nonprofit's exposures.

For example, will the insurer advance defense costs or require that the nonprofit pay counsel and await reimbursement by the company after they resolve the claim? Does the policy contain a broad definition of insured or is coverage limited to current directors and officers? Does the organization's policy manual provide broad coverage for employment practices liability or exclude employment-related claims? Given the growing number of D&O claims (especially employment practices allegations), nearly every nonprofit can benefit from buying a D&O policy. The current competitive marketplace for D&O coverage and most nonprofit organizations' lack of a loss reserve fund also support the benefits of purchasing D&O insurance.

Adopt and follow procedures. "Good procedures, regularly followed" could be the risk management mantra for any nonprofit. Several policies and procedures can be invaluable to a board as it strives to fulfill its legal duties and risk management responsibilities. These include the use of position descriptions for board members and an annual self-evaluation process, and the adoption of conflict of interest policies, attendance policies, and board minute procedures (The Alliance, 2002).

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