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LAW

Limit the risks and liabilities of serving on a nonprofit board

Text by Sheryl Howard

Say you are the president of a board of directors of a nonprofit day care provider. Your position is voluntary and uncompensated. You have some financial duties, such as co-signing checks, approving financial statements and hiring an accounting firm.

You know the day care has had some tax problems in the past, but you haven't looked into whether the day care is withholding payroll taxes or instituting appropriate controls. Suddenly, the IRS sends you a bill for $42,432 in trust fund penalties.

While you may think that this can't happen to you, in a recent case, Jefferson v. United States, the court held that the president of the board of a nonprofit day care may be held personally liable for the day care's unpaid payroll taxes under similar circumstances.

Serving on a nonprofit board is a great way to give back to your community and to support causes that are important to you. It is, however, not without risks.

For example, under the right circumstances, directors can be held liable for tax obligations, payroll and pension obligations, and obligations to lenders and other creditors. Since so many nonprofits are under financial pressure these days, these risks can become magnified.

As a result, it is a great time for you, as a director, to look into ways to limit your own liability (and strengthen the organization in the process). Here are five steps you can take to limit your liability as a director of a nonprofit:

• **Stay engaged.** As illustrated by the Jefferson case, turning a blind eye to the nonprofit's financial problems is a recipe for personal liability. As a director, you have fiduciary responsibilities with respect to financial oversight and legal compliance.

Even though it is tempting to avoid bad news, you should review financial statements at least monthly if the nonprofit is in financial trouble (otherwise, reviewing financials quarterly should be sufficient for most nonprofits).

Actively review the income and expense statements, balance sheets and budget status reports, and ask questions about the materials. Pay particular attention to the current ratio of assets to liabilities, fund balances and cash flow.

After this review, you will be in a good position to spot financial problems and develop solutions.

• **Take stock of governance policies.** Review the bylaws and board policies to determine whether your nonprofit has conflict of interest, annual disclosure document retention-destruction and whistleblower policies, and policies regarding minutes and other documentation of board actions.

Look for areas where the existing policies and procedures should be strengthened, and evaluate whether existing policies and procedures are being followed.

Take a close look at your audit or finance committee. Is the committee independent of the entity's employees and staff? Does the committee have the requisite experience? Taking stock of these policies and procedures may help you identify or avoid problems, document the basis for your decisions and reassure donors, the IRS and other government agencies.

• **Focus on key obligations.** Determine whether the nonprofit is in compliance with tax and regulatory requirements and, if not, find out how the entity plans to remedy the situation.

If the entity is behind on any of its tax obligations, immediately work to address the deficiency (for example, by negotiating a payment plan with the IRS). Find out whether the nonprofit has made any financial covenants in any loan documents.

Is the entity in default of these covenants (or about to default on these covenants)? If so, ask whether the entity has spoken with its lenders about defaults or pending defaults.

If the nonprofit is planning to cut staff or shut down its operations, make sure the layoffs will happen (making allowances for any required notices to

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employees) before the entity runs out of money to make payroll.

• **Don't accept compensation.** Massachusetts law offers some protection from tort liability in connection with performance of your duties as a director. You are only entitled to the protection, however, if you serve without compensation (other than reimbursement for actual expenses).

Keep in mind that the liability protection is not complete protection; it does not cover intentional misconduct and gross negligence and certain activities that are primarily commercial in nature.

• **Check the insurance.** Find out if the nonprofit carries directors and officers insurance. Since coverage can vary widely across insurers, find out what your policy covers.

Ask about whether the nonprofit carries "tail" or "extended reporting period" coverage, which covers claims made during the period of coverage but after the policy has been terminated.

If the nonprofit is considering shutting down operations, then this coverage can be important. Check to see if your existing homeowner's insurance policy covers your activities as a board member. If not, ask about whether you can purchase such insurance.

Not only will these steps help you protect yourself from liability, they will also help strengthen the nonprofit organization. Nonprofits with an active, engaged board and with strong governance policies will be in a better position to weather bad economic times.

By taking these steps, you will be limiting your own exposure and helping your organization further its mission.

Sheryl Howard is an attorney at Krokidas & Bluestein, Boston, who represents commercial, nonprofit and public clients in a variety of transactions with a concentration in real estate and taxmatters.