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Board Talking Points: Coping with Economic Downturn

Unfortunately, not-for-profit corporations are not immune to the pressures of the economic downturn. As government budgets are cut, foundation-giving declines and pressures on individual donations rise not-for-profit corporation will have fewer resources. These budgetary constraints will come at a time of increasing demand for vital social services. Charitable organizations will struggle to stretch their dollars and do more with less. Lawyers Alliance supports the resilience of New York City's not-for-profit sector and is beginning an ongoing dialogue on coping with the economic downturn that will coincide with our legal alerts.

Board Asserts Fiscal Oversight Responsibility

1. What are the common signs that a not-for-profit corporation is in financial distress?
2. What documents should board members ask to see?
3. Can the board meet more frequently or appoint a committee to monitor finances during the economic downturn?
4. Are there special rules that a board must follow during a period of economic distress?
5. What is the potential liability of individual board members for the debts of the not-for-profit corporation?

Detailed information:

What are the common signs that a not-for-profit corporation is in financial distress?

Not-for-profit boards of directors are always responsible for monitoring the fiscal health of corporations they run but this role takes on more importance during an economic downturn. Common signs that a not-for-profit corporation is in economic distress include: (i) use of cash reserves or endowment funds to meet ordinary course of business expenses; (ii) fully drawing upon a line credit; (iii) failure to timely pay expenses such as rent, utilities, vendors; (iv) failure to remit payroll taxes; and (v) failure to meet payroll.

What documents should board members ask to see?

Annual Budget

Year to Date Actual vs. Projected Budget

Quarterly financial statements

Cash flow projections

List of receivables and payables with aging data

Form 941 (withholding tax form) and evidence of remittances

Payroll Register

Can the board meet more frequently or appoint a committee to monitor finances during the economic downturn?

A board can choose to meet more frequently or appoint a committee of the board to monitor the organization's financial condition during this uncertain time. The New York Not-for-Profit Corporation Law (NPCL) provides that there should be an annual meeting of the members for the election of directors. NPCL section 603(b). The corporation's bylaws may provide that the board will meet a set number of times or a minimum number of times annually. To the extent that a board decides to add additional meetings it can notice a special meeting of the board. NPCL section 711(a). Most bylaws contain provisions detailing proper notice for a special meeting.

It is also appropriate for a board to decide to delegate fiscal monitoring to new board committee or an existing executive committee or finance committee. Working through a committee structure maybe a more practical option for larger boards that find it difficult to have detailed working sessions at board meetings. If it is necessary to create a new committee, boards can do so by resolution or as provided for in the certificate of incorporation or bylaws. A committee of the board must consist of three or more directors and can have the full authority of the board as provided for in the resolution except that a board committee cannot:

- (1) Submit to the members of any action requiring members' approval under this chapter.
- (2) Fill vacancies in the board of directors or in any committee.
- (3) Fix the compensation of directors serving on the board or on any committee.
- (4) Amend or repeal the bylaws or the adoption of new bylaws.
- (5) Amend or repeal any resolution of the board which by its terms shall not be amendable or repealable.

NPCL section 712(a).

Are there special rules that a board must follow during a period of economic distress?

The members of a not-for-profit corporation's board of directors have a fiduciary obligation to ensure that charitable assets are used for the charitable purposes for which they were raised and to best achieve the organization's mission. *See Right from the Start Responsibilities of Directors and Officers of Not-for-Profit Corporations* at page 8. When a not-for-profit corporation becomes insolvent the board of directors owes a fiduciary duty to all the constituents of the corporation – both the clients they serve and the organization's creditors. *See Intensive Care American Bankruptcy Institute Journal*, Sherri Morissette, March 2004.

http://findarticles.com/p/articles/mi_qa5370/is_200403/ai_n21346190?tag=content;coll

There are two primary tests to determine when a corporation is insolvent, the balance sheet test and the cash flow test. Under the balance sheet test, a corporation is considered insolvent when its liabilities exceed its assets. Under the cash flow test, a corporation is considered insolvent when it cannot pay its debts when they come due. *Id.* What this means for board members is that once the corporation is insolvent you need to exercise good faith to operate the organization in a manner that preserves corporate assets so that creditors can be paid and clients served.

What is the potential liability of individual board members for the debts of the not-for-profit corporation?

As a general matter, the volunteer board members not personally liable for the debts of the corporation. NPCL section 720-a. There are four major exceptions to this general rule:

- (1) Violation of a director's fiduciary duty, NPCL section 719;
- (2) Failure to pay payroll, New York State Labor Law sections 197 and 198-a;
- (3) Failure to remit trust fund portion of payroll taxes, See Publication 15, Circular Employer's Tax Guide at page 24,
<http://www.irs.gov/formspubs/lists/0,,id=97819,00.html>
- (4) Undertaking a personal obligation (e.g. in your personal capacity guaranteeing the corporation's lease).

Lawyers Alliance can help boards as they deal with these difficult issues. For more information please contact Linda Manley, Legal Director, at (212) 219-1800 ext. 239, لمانley@lawyersalliance.org.