

Insights for fiduciaries

Fiduciary responsibilities for nonprofits

Who is impacted when a nonprofit organization's investment decision results in a loss? The fiduciaries are, which is why fiduciaries need to understand the scope of their responsibilities and live up to their fiduciary obligations, or risk personal liability for their investment decisions. If in doubt about their investment acumen, fiduciaries can limit their exposure by consulting with competent investment consultants.

This paper helps explain fiduciary obligations to assist directors, officers, trustees and other nonprofit fiduciaries to get a handle on the nature of their duties.

Governance: Who is a fiduciary?

Each nonprofit organization has individuals serving in governance roles who work together to direct, manage and oversee the organization's affairs. An individual may occupy more than one governance role at a time; however, each role has its own distinct purpose. Some governance roles have fiduciary obligations to the nonprofit and some do not. While the categories of governance may go by different names at different nonprofits, their functional descriptions are generally as follows:

- Members—those with the power to appoint members of the board but do not themselves have fiduciary responsibilities to the organization (unless they also hold one or more positions)
- Directors or trustees—those who hold and exercise all of the legal powers of the entity and bear full fiduciary responsibility to it
- Officers—those to whom the board has delegated the daily management of the organization and who also bear fiduciary responsibility to the organization. The officer role generally includes the following positions: president, executive director or chief executive officer with executive decision-making responsibility; treasurer, controller or chief financial officer with the responsibility to maintain the books and financial records of the organization; and secretary or clerk with the responsibility of keeping the minutes, policies and other legal records of the organization.

As a general matter, all powers conferred upon a fiduciary are held in a fiduciary capacity rather than a personal capacity. The fiduciary, therefore, must exercise those powers in good faith and serve the interests of the nonprofit organization and its charitable class rather than the fiduciary's personal benefit. An individual's powers to act in a fiduciary capacity are generally discretionary, except to the extent they are directed by the terms of the organization's governing instrument or compelled by fiduciary duties.

Statutory fiduciary responsibility

Each state has enacted statutory laws on prudent investing that supplement the common law and provide guidance to charities about investment decisions. The Uniform Prudent Management of Institutional Funds Act ("UPMIFA") governs the investment, management and expenditure of endowment funds. UPMIFA applies to charities organized as nonprofit corporations, state governmental entities that hold funds for charitable purposes, as well as other organizations; however, it does not apply to trusts unless there is a charity serving as trustee of the trust.

The Uniform Prudent Investor Act ("UPIA") applies to charities organized as trusts. The rules regarding investment decision-making are nearly identical between UPMIFA and UPIA because UPMIFA is based on the UPIA.

Every state except for Pennsylvania (which has its own, similar rules) has adopted UPMIFA, and all but nine states (Delaware, Florida, Georgia, Illinois, Kentucky, Louisiana, Maryland, New York and South Dakota) have adopted UPIA.

These uniform acts provide that fiduciaries who invest and manage a nonprofit's assets owe a duty to the organization or its charitable beneficiaries to invest and manage the organization's assets as a prudent investor would by considering the purposes, terms, distribution requirements and other circumstances. In satisfying this standard fiduciaries are required to exercise reasonable care, skill and caution.

UPMIFA and UPIA establish the “prudent investor” standard, which generally requires investment managers to be informed by the following factors when making investment decisions:

- The institution’s investment policy
- The purposes of the institution and the endowment fund
- The duration and preservation of the endowment fund
- The needs of the institution and the fund to make distributions and to preserve capital
- Other resources of the institution
- General economic conditions
- The possible effect of inflation or deflation
- The expected total return from income and the appreciation of investments
- The expected tax consequences, if any, of investment decisions or strategies
- The role that each investment or course of action plays within the overall investment portfolio of the fund
- An asset’s special relationship or special value, if any, to the charitable purposes of the institution

UPIA and UPMIFA also generally instruct institutions to apply a whole portfolio management approach, diversify and rebalance portfolios, and consider the charitable purposes of the institution and a particular fund when managing and investing funds (unless the donor specifically provides otherwise).

In addition, the statutes permit institutions to incur only appropriate and reasonable management and investment costs and generally require institutions to make a reasonable effort to verify facts relevant to the management and investment of a fund.

Fiduciaries who have special skills or expertise, or are named to their fiduciary position in reliance upon their representations that they have special skills or expertise, have a duty to use those special skills or expertise. Fiduciaries of nonprofits are also obligated to invest and manage the nonprofit’s assets solely in the interest of the organization and to make a reasonable effort to verify facts relevant to the investment and management of its assets.

Both UPMIFA and UPIA allow directors and officers of nonprofit organizations to delegate investment management duties to agents and outside consultants.¹ This enables the directors and officers of the nonprofit to constrain the scope of their obligation to overseeing the investment consultant, which involves considerably less personal risk than conducting the investment management. An investment consultant is itself a fiduciary for those services for which it is contracted, and it has a duty to exercise reasonable care in performing the investment management function.

The delegation of investment management duties to an agent or consultant, however, does not fully absolve the nonprofit’s directors and officers of their duties. Specifically, UPMIFA and UPIA generally require that the nonprofit’s directors and officers:

- act prudently and in good faith in selecting the investment manager;
- establish the scope and terms of the delegation in a manner that is consistent with the purposes of the institution and the institutional fund; and
- monitor the investment manager’s performance and compliance

Common law fiduciary responsibilities²

The business judgment rule and the fundamental fiduciary principles of care, loyalty, obedience and impartiality to the mission apply to all decisions made by fiduciaries.

A. Business judgment rule

The key issue for fiduciaries is the business judgment rule because it protects them from personal legal liability. The business judgment rule is a set of normative and procedural rules that enable fiduciaries to establish that a decision made in their capacity as fiduciaries was in the best interest of the organization regardless of whether the decision results in harm to the organization. When a fiduciary exercises discretion to make decisions on behalf of the organization, a court generally will accept the exercise of that discretion as dispositive unless the fiduciary acts dishonestly or with an improper, even though not a dishonest, motive; fails to use his or her judgment; or acts beyond the bounds of reasonable judgment in exercising or failing to exercise the power.³ In particular, a court will not interfere with the exercise of discretion by fiduciaries in accordance with their fiduciary duties merely because the court would have made a different determination had the discretion been vested with the court rather than the fiduciaries.⁴

Factors that courts generally take into account when determining whether a board action falls outside the business judgment rule include whether:

- the board honestly and rationally believed its decision was in the best interests of the organization;
- the board conducted an adequate investigation into the matter;
- the board received legal advice;
- the board documented the basis for its determination; and

- the action was approved by disinterested board members, generally meaning board members without any material direct or indirect financial interest in or with respect to a transaction

B. Duty of care

The duty of care, sometimes referred to as the duty of prudence or prudent administration, requires fiduciaries to make decisions on behalf of the nonprofit with the care and skill that an ordinary prudent person would observe when dealing with the property of another.⁵ This requires exercising reasonable care and skill in administering or overseeing the organization and acting with a degree of caution appropriate to the particular circumstances.⁶ Fiduciaries are required to act in good faith and to be sufficiently informed about the matter at issue by making appropriate inquiries and investigations under the circumstances before making decisions.⁷ For this reason, it is important for fiduciaries to inform themselves of the material facts necessary to properly exercise their business judgment. The test of prudence is determined based on the fiduciary's decisions and actions rather than the outcomes of those decisions and actions, and the fiduciary's conduct is assessed based on the circumstances that existed when decisions were made rather than with the benefit of hindsight.⁸

What constitutes appropriate due diligence and the factors that should be considered when managing a nonprofit's assets depends on the nature of the issue or activity.⁹ General factors to consider include the terms and purposes of the nonprofit, the value and nature of the nonprofit's assets, and, for term-limited trusts, the organization's likely duration.¹⁰ Obtaining and considering advice from competent legal counsel may be necessary or appropriate in order to make informed decisions under the circumstances.¹¹

With respect to making decisions about legal matters, fiduciaries may rely on the opinion of reputable counsel in determining the possibility of success in legal proceedings in order to arrive at a judgment whether to pursue such a course of action. Seeking and following the advice of competent counsel is an important factor in demonstrating prudence by fiduciaries in the exercise of their discretion.¹²

Fiduciaries may delegate certain tasks to agents, including the selection and evaluation of investments, provided that the fiduciary monitors the agent's activities and does not continue to rely on an agent who has ceased to perform the delegated task competently. Boards of nonprofit

organizations may not unduly rely on the corporation's officers or agents, and failing to exercise an appropriate level of oversight can result in serious financial consequences both for the corporation and for directors themselves. For example, directors who had "actual knowledge of mismanagement, yet stuck their heads in the sand in the face of repeated signs that residents [of a nursing home] were receiving care that was severely deficient," were found to have breached their fiduciary obligations to the nonprofit organization.¹³

C. Duty of loyalty

The duty of loyalty requires fiduciaries to make decisions based solely on what the fiduciary reasonably believes to be in the best interests of the organization and in furtherance of its charitable purposes, to put the fiduciary's duties to the organization first, and not to act for personal benefit.¹⁴ This rule generally prohibits the fiduciary from engaging in self-dealing transactions unless the conflict is otherwise discharged by disinterested members of the governing body. It also prohibits the fiduciary from investing funds in a manner that benefits a third party or serves a nonexempt objective.

Fiduciaries generally have a duty not to be influenced by the interest of any third person or by motives other than the accomplishment of the nonprofit organization's purposes.¹⁵ Fiduciaries may not take into consideration their own interests or enter into transactions to advance an objective other than the purposes of the organization.¹⁶ Thus, when making decisions on behalf of the organization, fiduciaries must consider only what is in the best interests of the organization without consideration of their personal interests or preferences.

D. Duty of obedience and impartiality

Fiduciaries have a duty of obedience to the organization's mission that requires them to be faithful to the charitable purposes and goals of the organization and to ensure that its mission is carried out.

Fiduciaries have a duty to make decisions consistent with the purposes for which the nonprofit organization was organized.

To satisfy their duty of obedience, fiduciaries should:

- understand the mission of the organization;
- make decisions with a view toward furthering the organization's mission; and

- avoid “mission drift” (i.e., deviation away from the purposes for which the organization was formed).

The fiduciary obligation of obedience is akin to the duty of trustees to act impartially with regard to the charitable class benefiting from the organization’s activities, treating present and future beneficiaries impartially, taking into account any differing interests, and not favoring any beneficiary or interest over another.¹⁷ Stated differently,

trustees have the duty to “hold an even hand, and to do the best for the estate, looking upon it as a whole.”¹⁸ The duty of impartiality does not mean that the fiduciaries must treat the interests of all charitable beneficiaries equally. Rather, they must consider and balance those interests in a manner that shows due regard for the beneficial interests, terms and purposes of the organization.¹⁹

¹ See UPMIFA § 5 and UPIA § 9.

² The most well-developed body of law addressing fiduciary obligations is in the context of nonprofit trusts, as expressed in the Restatement of Trusts, and the discussion below will focus on nonprofit trusts and trustees for that reason. Similar rules apply to directors and officers of nonprofit corporations. Fiduciaries should consider the statutory and common law of their state of jurisdiction for any nuances or further development of the general principles discussed below.

³ See Scott and Ascher on Trusts, vol. 4, § 382.

⁴ See Restatement (Second) of Trusts § 187 cmt. e.

⁵ Scott and Ascher on Trusts § 17.6 (2017).

⁶ Restatement (Third) of Trusts § 77 cmts. a, b.

⁷ *Id.*

⁸ *Scott and Ascher on Trusts § 17.6 (2017).*

⁹ *Restatement (Third) of Trusts § 77 cmt. b(1).*

¹⁰ *Id.*

¹¹ *Id.* § cmts. a, b.

¹² Restatement (Third) of Trusts § 77 cmt. b(2).

¹³ *In re Lemington Home for the Aged*, 777 F.3d 620 (3d Cir. 2015) (directors of a Pennsylvania nonprofit nursing home breached duty of care because they failed to fire the company’s Chief Executive Officer and Chief Financial Officer despite knowledge that both officers were incompetent based on repeated warnings for more than six years about a dismal financial state of affairs, health code violations, program mismanagement that contributed to the preventable death of two nursing home patients, and knowledge that the CFO did not keep adequate financial records).

¹⁴ Model Nonprofit Corporation Act Third Edition § 8.30 (2008); Restatement (Third) of Trusts § 78.

¹⁵ *Id.*

¹⁶ *Id.*; Restatement (Third) of Trusts § 78 cmt. f.

¹⁷ Scott and Ascher on Trusts § 17.15 (2017); Restatement (Third) of Trusts § 79(2).

¹⁸ Scott and Ascher on Trusts § 17.15 (2017).

¹⁹ Restatement (Third) of Trusts § 79 cmts. b, h.

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