Duties [illegible]ties of Non[illegible]tors and Officers

Directors and officers of nonprofit corporations play an important role in helping these entities fulfill their goals. But before agreeing to serve as a director or officer, an individual must understand his or her duties and responsibilities.

AVI Z. KESTENBAUM, ATTORNEY

Recent developments have increased the duties and obligations of nonprofit corporation boards of directors and officers, and may have increased their liability standards as well. This article focuses on some of these developments, provides insight into understanding the duties and obligations of nonprofit directors and officers, and offers guidance on affirmative steps to minimize the liability of these individuals.

Fiduciary duties for nonprofit directors and officers

A nonprofit corporation may be defined as a corporation "barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors or trustees," and is distinguished by "the absence of stock or other indicia of ownership."[1] Most nonprofit corporations are exempt from state income tax under state statutes and are free from federal income tax under IRC Section 501(c)(3). Most nonprofits also receive special treatment under state and federal legislation in other areas, including but not limited to: reduced postal rates, charitable deduction to donors, exemption from minimum wage requirements, and the ability to issue tax-exempt bonds.[2]

Nonprofit directors and officers have two primary duties: the duty of care and the duty of loyalty.[3] These duties are owed to their organizations and in certain circumstances to third parties (which will be discussed later in the section on "Standing to sue"). These duties are also imposed on board members of nonprofit committees in fulfillment of their committee duties.[4]

The duty of care is defined in the Revised Model Nonprofit Corporation Act and in statutes of the majority of states. The Revised Model Nonprofit Corporation Act defines "duty of care" in section 8.30: General Standards for Directors:

> (a) a director shall discharge his or her duties as a director, including his or her duties as a member of a committee:
>
> (1) in good faith;
>
> (2) with a care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (3) in a manner the director reasonably believes to be in the best interests of the corporation.[5]

The duty of care mandates that directors be informed and act in good faith. If a director acts in good faith with the requisite degree of care and within her authority, the director will have fulfilled her duties under the duty of care.[6] The duty of care encompasses the "manner in which the directors exercise their responsibilities, rather than a decision's correctness or benefit to the organization."[7] Among the important requirements under the duty of care are

to be informed, attend board meetings, have access to all organization information, and make informed decisions.[8]

The second primary duty is the duty of loyalty. Loyalty is defined as "pursuing the corporation's best interest rather than those of your own or others—in other words, avoiding conflicts of interest, whether over money or politics. The duty of loyalty prohibits the director from engaging in self-dealing unless there is full disclosure to the board and the transaction is clearly in the corporation's best financial interest."[9] The duty of loyalty requires a director's faithful pursuit of the interest of the organization he serves, rather than the financial or other interests of the director or another person or organization.[10]

Directors and officers must avoid self-dealing activities and must act in the best interest of the organization under the duty of loyalty. However, directors and officers are not prohibited from all acts of self-dealing as long as there are guidelines in place for full disclosure of any self-dealing activity or conflict of interest to the board of directors, and the self-dealing activity is fair and reasonable.[11]

The Revised Model Nonprofit Corporation Act (like many state nonprofit corporation acts) has three fundamental requirements with regard to self-dealing by directors and officers. The first requirement is that there be adequate disclosure to the board of directors regarding all facts and circumstances of the self-dealing activity. Second, the self-dealing activity must be fair and reasonable and similar to the activity the nonprofit corporation would be conducting with a non-interested person in pursuit of its goals. The third requirement is that the activity be authorized by the certificate of incorporation or the bylaws, and it must be approved by an independent board of directors who has no direct or indirect interest in the transaction.[12]

Standard of liability for nonprofit directors and officers

Today, nonprofit directors and officers are generally held to the same standard as are their for-profit business corporation counterparts. For many years, nonprofit officers and directors were held to the standard of a trustee, which is a higher standard.[13] A trustee is generally liable for "ordinary negligence" even if he exerts a good faith effort and reasonably believes that his actions are appropriate. A trustee "is under a duty ... to exercise such care and skill of a person of ordinary prudence would exercise, and he is liable for loss resulting from his failure to comply with the standard, even though he does the best he can."[14] Additionally, good faith reliance on the advice or representations of others is generally no defense to the negligence standard.[15]

A corporate director or officer is generally held liable only for "gross negligence" and not "ordinary negligence," and will be protected if he relied in good faith on the advice or representations of others.[16] (See the discussion later in the section "Business judgment rule and statutory protections.")

Approximately 35 years ago, the standard of liability for nonprofit directors and officers formally shifted from the trustee standard to the corporate standard. "The modern trend is to apply corporate rather than trust principles in determining the liability of directors of charitable corporations."[17] The Revised Model Nonprofit Corporation Act also adopted this change in section 8.30(e) which states: "A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property."[18]

Standing to sue

An important question for tax-exempt organizations is who has standing to sue for breach of duties by the nonprofit director and officer. The question arises as to who has a "sufficient stake in an oth-

[1] See Lee, "Note: The Business Judgment Rule: Should It Protect Nonprofit Directors?," 103 Colum. L. Rev. 925 (2003) (citing Hansmann, "The Role of Nonprofit Enterprise," 89 Yale L.J. 835, 838 (1980)).

[2] *Id.*

[3] There is the opinion that there is also a "duty of obedience." This duty is cited in the ABA publication *Nonprofit Governance and Management* (2002), Chapter Eight, by David B. Rigney, at page 87. However, the Corporate Laws Committee of the American Bar Association Section of Business Law does not recognize the "duty of obedience," but instead sees it as a subset of the "duty of loyalty." See *Corporate Directors Guidebook*, p. 10.

[4] Abbey, *Corporate Governance: A Guide for Not-for-Profit Directors*, p. 27 (1996).

[5] Revised Model Nonprofit Corporation Act (1987).

[6] Fishman, "Improving Charitable Accountability," 62 Md. L. Rev. 218 (2003).

[7] *Id.* at p. 232.

[8] Kestenbaum and Shin, *Exempt Organizations and Charitable Activities in New Jersey* (2003).

[9] Abbey, *supra* note 4, at p. 26.

[10] Kurtz, *Board Liability; Guide for Nonprofit Directors* (1988).

[11] Kestenbaum and Shin, *supra* note 8.

[12] See, e.g., N.J.S.A. 15A:6-11 through 15A:6-14.

[13] See Eurich v. Korean Foundation, 31 Ill. App. 2d 474 (1961).

[14] Scott, *The Law of Trusts*, § 201, at p. 220 (4th Ed. 1988).

[15] *Id.* at p. 221.

[16] Block, et al., *The Business Rule: Fiduciary Duties of Corporate Directors* (5th Ed. 1988).

[17] Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, et al., 381 F. Supp. 1003 (DC D.C., 1974). See also, Denckla v. Independence Foundation, 193 A. 2d 538, 541 (Del. Ch., 1963).

[18] Revised Model Nonprofit Corporation Act (1987).

erwise justifiable controversy to obtain judicial resolution of that controversy."[19] Generally, there are four potential classes of plaintiffs who might have a sufficient stake in the tax-exempt organization to sue a director or officer for breaching his fiduciary duty. These potential classes of plaintiffs are: state attorneys general, beneficiaries with a "special interest," fellow directors, and members.

The vast majority of states vest the authority to oversee the affairs of tax-exempt corporations with the state attorney general. The power of state attorneys general to bring suit against tax-exempt organizations, as well as against directors and officers, has long been recognized at common law, and many states have also codified this rule in their tax-exempt corporation statutes.[20]

Beneficiaries with a "special interest" in tax-exempt corporations, or for that matter beneficiaries of charitable trusts, also have standing to sue officers and directors for violation of their fiduciary duties.[21] The plaintiffs must be members of a small, identifiable class that the charity is designed to benefit in order to have the special interest to sue.[22] Generally, a mere possible beneficiary of a nonprofit corporation or charitable trust does not have standing to sue.[23]

The standing of nonprofit directors and officers to sue fellow directors and officers for breach is a third class that has been recognized by the courts.[24] In many circumstances, the board of directors and officers may actually owe a duty to sue for breach of duty by fellow officers and directors, and failure to bring suit may be a breach of duty by the non-breaching officers and directors. Nevertheless, directors' and officers' standing to sue has limited effect because of the disincentives of directors and officers to sue each other.[25]

Similarly, members of nonprofit corporations, akin to shareholders of for-profit corporations, generally have standing to bring suit against directors and officers for fiduciary violations.[26] The lawsuit would be on behalf of the nonprofit corporation in a "derivative action," and any funds recovered would go directly to the nonprofit corporation. Similar to directors' and officers' lawsuits, members typically have little incentive to sue because the nonprofits determine the terms of membership, and any damages obtained will be awarded to the nonprofit corporation.[27]

Business judgment rule and statutory protections

Nonprofit officers and directors, like their for-profit counterparts, are protected by the "business judgment rule," which provides that even if decisions of officers and directors turn out to be in error, the officers and directors will not be held liable so long as informed and reasonable decisions were made based on a mere error of judgment.[28] An important area where this occurs is in the management of the nonprofit corporation's assets and investments, which requires directors and officers to show reasonable judgment; however, the directors and officers are not responsible for errors if they exercise reasonable business judgment.[29] Both the Model Act and case law provide that the business judgment rule will apply to protect nonprofit directors.[30] On the other hand, the business judgment rule will not protect the officer and director for violating their duty of loyalty and for decisions made in bad faith and with dishonesty.[31]

The laws of many states, including Delaware, provide that a nonprofit corporation may adopt a provision in its articles of incorporation or bylaws "eliminating or limiting the personal liability of a director to the corporation or its [members] for monetary damages for breach of fiduciary duty as a director."[32] Moreover, all states have statutes limiting liability to varying degrees, especially limiting liability to directors and officers serving without compensation.[33] Provisions regarding liability protection and indemnification are common in the articles of incorporation of nonprofit corporations because, without adequate protections for directors from fiduciary liability, many officers and directors would not serve, especially those serving without compensation.

The Model Act also provides that a director who has discharged his duties in good faith and con-

19 Sierra Club v. Morton, 405 U.S. 727, 731-732 (S.Ct., 1972).

20 See, e.g., N.J.S.A. 45:17A-18 *et. seq.* See also Lopez v. Medford Community Center, 424 N.E.2d 229 (Mass., 1981).

21 See Jones v. Grant, 344 So. 2d 1210, 1212 (Ala., 1977).

22 See Blasko, Crossley, and Lloyd, "Standing to Sue in the Charitable Sector," 28 U.S.F. L. Rev. 37 (1993).

23 *Id.*

24 See Holt v. College of Osteopathic Physicians and Surgeons, 61 Cal. 2d 750 (1964). See also Eurich v. Korean Foundation, *supra* note 13.

25 Lee, *supra* note 1.

26 See, e.g., N.J.S.A. 15A:6-12. See also Oberly v. Kirby, 592 A. 2d 445, 458-459 (Del., 1991).

27 Lee, *supra* note 1.

28 See Boston Children's Heart Foundation, Inc. v. Nadel-Ginard, 73 F.3d 429, 433 (CA-1, 1996). See also Parish, et al. v. Md. and Va. Milk Producers Ass'n, Inc., 277 A. 2d 19, 48 (Md., 1971).

29 Kestenbaum and Shin, *supra* note 8.

30 See Model Act § 8.30, comm. 3. See also Oberly v. Kirby, *supra* note 26.

31 See Smith v. Van Gorkum, 488 A.2d 858, 872 (Del., 1985), and Scheuer Family Foundation, Inc. v. 61 Associates, 582 N.Y.S. 2d 662, 665 (N.Y. App. Div. 1st Dept., 1992). See also North Carolina v. Ila Corp., 132 N.C. App. 587, 513 S.E.2d 812 (1999).

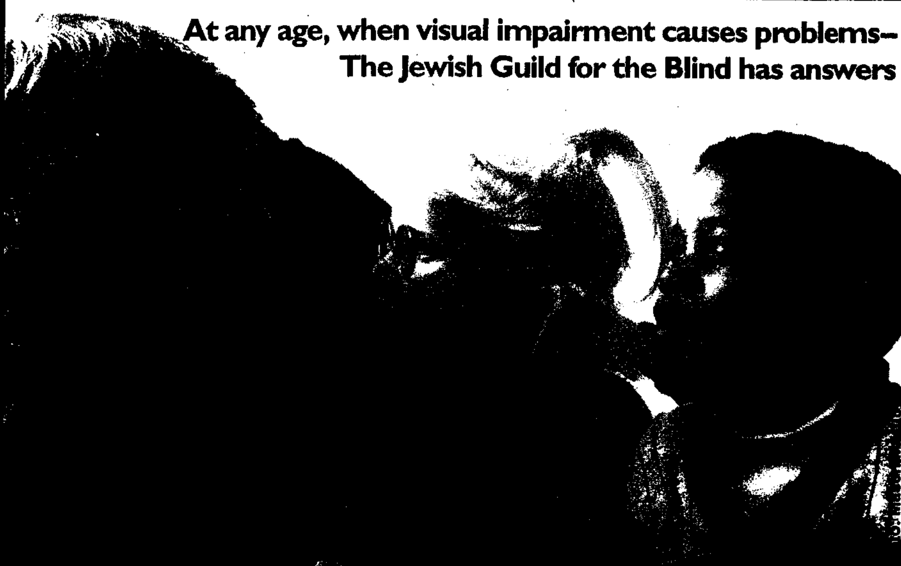
32 See, e.g., Del. General Corp. Law § 102.

33 See Lee, *supra* note 1. See also, e.g., N.Y. Not-for-Profit Corp. Law § 720-a.

For almost 90 years, The Guild has served the needs of blind, visually impaired and multidisabled persons of all ages, races, creeds and nationalities.

To plan a Gift or a Bequest, contact David J. Iommarini, Director of Development at 212/769-6240.

www.jgb.org



THE JEWISH GUILD FOR THE BLIND • 15 WEST 65TH STREET, NEW YORK, NY 10023

sistently with the provisions will not be liable to the corporation, any member, or any other person for any action taken or not taken as a director.[34] Nevertheless, intentional misconduct, a knowing violation of the law, or receipt of improper personal benefit cannot be protected by a provision adopted by the nonprofit corporation in its articles of incorporation.[35]

Recent developments

The Sarbanes-Oxley Act ("Sarbanes-Oxley" or the "Act") was signed into law by President Bush on 7/30/02 "to protect investors by improving the accuracy and reliability of corporate disclosures."[36] The Act was passed in direct response to a series of recent corporate and accounting scandals. While Sarbanes-Oxley on its face is applicable only to publicly traded companies, it has had an impact on the current trend of heightened scrutiny and regulation in the nonprofit sector as well.

In response to the Act, New York State Attorney General Eliot Spitzer proposed amendments in January 2003 to the New York Not-for-Profit Corporation Law. These proposed amendments would apply certain provisions of Sarbanes-Oxley to nonprofit corporations in New York, including: certification of annual reports, establishment of executive and audit committees, limiting the scope of indemnification for officers and directors, proposals regarding interested director transactions, and compensation of directors and officers. It is the author's understanding from speaking to individuals in the offices of several other state attorneys general that other states are waiting to see whether the New York proposed legislation passes, and then they may eventually propose similar legislation.

Furthermore, the IRS, in Ann. 2002-87,[37] in the section entitled "Corporate Responsibility," stated that it was seeking to update Form 990 (federal tax return for many exempt organizations) in direct response to the recent events concerning the integrity of financial disclosures by publicly traded companies. Ann. 2002-87 stated: "It may be argued that there are similarities between the need for veracity and the public information used by shareholders in making investment decisions and the need for veracity in the public information used by contributors and others in making decisions regarding exempt organizations. As a result, the Service is considering whether the Form 990 or other requirements should be modified to provide similar measures to increase public confidence in the integrity of disclosures by exempt organizations."

Among the additional requirements to the Form 990 that the IRS is considering are disclosures regarding whether conflict of interest policies have been adopted, whether there are independent audit committees, and whether certain exempt organizations should be required to disclose information about transactions with substantial contributors, officers, directors, trustees and key employees, plus

[34] See Model Act § 8.30(d).
[35] See, e.g., Del. General Corp. Law § 102.
[36] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (7/30/02); Conf. Rep't on H.R. 3763.
[37] 2002-39 IRB 624 (issued 9/30/02).

any other changes to Form 990 which would increase public confidence in the integrity of exempt organization disclosures.

Another area where the duties and obligations of nonprofit corporation officers and directors have increased involves "terrorism and philanthropy." There have been many recent news articles regarding charities being used as conduits to fund terrorism. In fact, in August 2003, President Bush froze the assets of five overseas charities for being conduits of terrorist organizations.

In November 2002, the U.S. Department of the Treasury issued "Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities." These guidelines outline recommended procedures, insuring that funds of charities are not diverted for terrorism. The best practice guidelines for U.S.-based charities making international grants include the following: searching public information to determine if the grantee organization has been implicated in any questionable activities or appears on any lists provided by the U.S. Government, United Nations and European Union on organizations linked to terrorism; requiring the foreign recipient organization to certify that it does not employ or deal with any entities or individuals on the lists; identifying financial institutions with which the recipient maintains accounts; conducting on-site audits; and requiring periodic reports from the foreign recipient organization on its operational activities and use of the disbursed funds.[38]

Another recent development that compels directors and officers to understand clearly their increased responsibilities concerns charitable solicitation. Most states require charities that solicit contributions from the public, as well as any paid fundraisers, to register with the state. A recent U.S. Supreme Court case, *Madigan v. Telemarketing Associates, Inc., et al.*,[39] has further increased the duties and obligations of a nonprofit corporation when soliciting funds.

Madigan involved a paid telemarketing fundraiser that solicited funds for a tax-exempt organization registered as an Illinois charitable trust. The telemarketer failed to tell potential donors that 85% of the gross collections would be paid to the fundraiser. The Supreme Court held that the misleading solicitation was not protected by the First Amendment right to free speech, and that the State of Illinois could bring a claim for common law fraud and breach of fiduciary duty and fraud under Illinois state statutes. In three earlier Supreme Court cases, the Court took the more favorable position that state regulations of charitable solicitation, barring fees in excess of a prescribed level, imposed restraints on fundraising that were in violation of the First Amendment.[40] This is another example of increased scrutiny on the activities of nonprofit corporations and charities in general.

Other recent developments that may increase the fiduciary duties of nonprofit directors and officers include limited state taxation of exempt organizations, application of "do-not-call lists" to charities and independent paid fundraisers, further IRS reforms and changes to the annual informational return (IRS Form 990) of certain exempt organizations, and increased penalties under the Internal Revenue Code for self-dealing activities.

Practical guidance to minimize liability

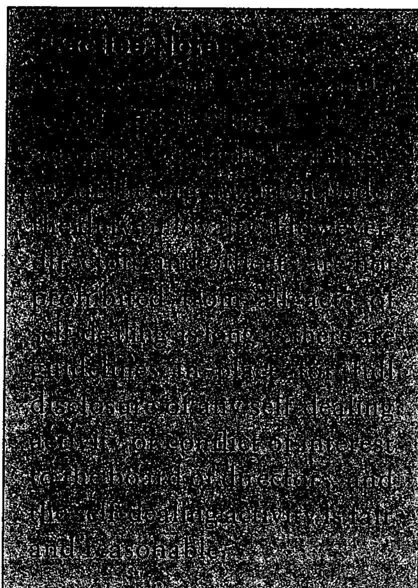
There have been many books written on practical guidance to officers and directors in fulfilling their duties and minimizing their liability. This article provides an overview of the areas on which directors and officers should focus their attention, which will help them develop and formulate a plan to understand their duties better and minimize their liability:

1. Be aware of the structure and operation of the nonprofit organization before accepting a role as director or officer. This includes understanding the legal structure and operation of the organization as well as its current and past activities. Pay careful attention to any specific liability risks to the director and officer, as well as provisions in the articles of incorporation, bylaws, and state law minimizing risk and liability. The director and officer may want the organization to purchase a director and officer liability insurance policy, which will provide further protection.
2. Always be informed about the operations of the organization. This is the fundamental requirement under the duty of care. Ongoing operations encompass board meetings, oversight committees (including standing and special committees), committee reports, and reports of legal and financial advisors. As long as there are procedural safeguards in

[38] U.S. Department of Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities.

[39] 538 U.S. 600 (S.Ct., 2003).

[40] See Schaumberg v. Citizens for a Better Environment, 444 U.S. 620 (S.Ct., 1980); Secretary of State of Md. v. Joseph H. Munson Co., 467 U.S. 947 (S.Ct., 1984); Riley v. Nat'l Federation of Blind of N.C., Inc., et al., 487 U.S. 781 (S.Ct., 1988).



place for the director and officer to be informed about the ongoing operations, the director/officer will probably have fulfilled his duty of care even if he later makes a decision in error.

3. Be aware of particular tax and legal issues affecting the nonprofit organization. The Internal Revenue Code as well as state statutes have many specific requirements for tax-exempt organizations. Directors and officers should understand the type of entity that is at issue, the requirements for such an entity, and whether the entity is in compliance. Failure to be in complete compliance may result in the imposition of IRS and state penalties on the directors and officers, as well as on the organization, and may lead to the potential loss of tax-exempt status.
4. Be aware of any special circumstances involving the organization, such as dispositions of property, mergers, sales, and other events that may trigger specific liability problems.
5. Define the mission of the organization and constantly review its activities and operations in furtherance of this mission.
6. Consult with a legal advisor periodically regarding any changes in the law which may affect the organization.
7. Know your employees, their roles, and their duties. A director and officer may be responsible for the acts and failure to act of his employees.
8. Have a conflict of interest policy in place, which will provide guidelines and procedures regarding self-dealing activities, to ensure compliance with the duty of loyalty.
9. Understand to whom the duties and obligations are owed. Directors and officers owe duties to their organization, their fellow officers and members, and "special interest" beneficiaries.
10. Understand the charitable solicitation activities of the entity and ensure that the entity is in compliance with state and federal requirements.
11. Understand any political or lobbying activities of the entity which could potentially cause the entity to lose its tax-exempt status.
12. Understand the delegation of authority and chain of command.
13. Evaluate the performance of the directors and officers periodically.
14. Limit the terms of directors and officers to ensure independence and proper oversight.
15. Develop an audit committee to review the structure, finances, activities, and compliance of the entity. The audit committee should be an independent committee to assure that it will objectively review the performance of the management and directors and officers.
16. Comply as much as possible with the "Voluntary Best Practices" issued by the U.S. Treasury when making overseas grants.

Conclusion

Directors and officers of nonprofit corporations play a valuable role in society by assisting those entities fulfill their missions and goals. However, before accepting the position of director or officer, or if currently serving as a director or officer, an individual must understand the duties and responsibilities. This will allow him to better perform his role as well as limit his liability. Consulting with attorneys and other outside advisors who specialize in this field is always good practice. ■