NON-PROFIT ORGANIZATIONS

GENERAL ISSUES FOR THE BOARD OF DIRECTORS

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This outline references the Model Nonprofit Corporation ACT ("MNCA"), Third Edition (2008). Most states have not adopted the entire model act and it is important to review the governing act. For instance, the law governing nonstock corporations in Delaware is the same as the law that governs for-profit corporations (Delaware General Corporation Law).

I. Board of Directors as the Governing Body

A. Board Requirement.

A nonprofit corporation must have a board of directors. MNCA §8.01. Generally, "...[A]ll corporate powers must be exercised by or under the authority of the board of directors of the nonprofit corporation and the activities and affairs of the corporation must be managed by or under the direction, and subject to the oversight, of its board of directors."

B. Size.

States differ, but generally a board must include three directors. Directors must generally be individuals (entities cannot serve as directors). A common mistake made by organizations is to create a board of directors with too many directors. If a large board is desired, consider authorizing an executive committee which will have the authority to act for the entire board if it is not in session. Alternatively, keep the main board small and create advisory committees or groups. For a deliberative board of directors, 6-12 members is recommended. This is large enough to allow for dissenting views and a fair amount of diversity but small enough to have every director fully engaged in the discussion. If the organization believes it must elect donors as directors in order to fundraise successfully, then it may have to compromise and have a larger board. The organization may want to counteract a larger board by emphasizing the decision-making power of an executive board or committee structure. Many high profile organizations operate in this manner to great success.

C. Board Make-up.

The organization may formally (in its bylaws) or informally designate "slots" or preferences as to the types of people to serve in each role. This is especially important if the organization's board must or should represent certain constituencies or if the organization needs expertise in its board. Sometimes organizations draft and adopt formal statements to ensure this representation.

i. Executive Committee to act on behalf of the organization in lieu of the full board. The delegation to the executive committee may be complete or it may be limited in some way (i.e., cannot remove directors and officers, cannot amend the bylaws, or cannot adopt a budget).

ii. Compensation Committee to set compensation (if the executives are paid).

iii. Audit Committee to review and approve the financials.

iv. Governance and Nomination Committee to recruit and nominate new board members (with an eye towards diversity, expertise, fundraising, and representation goals).

F. Meetings of the Board of Directors.

Under state law, organizations must have an annual meeting and also have regular meetings and special meetings. The organization may also have regular meetings and special meetings of either members or directors. The bylaws may state that notice is not required for regularly scheduled meetings. Meetings must be called and noticed appropriately, if notice is required. The bylaws should state what qualifies for notice. Generally, if the notice requirements have not been met, any actions taken at the meeting may be considered void.

The bylaws should specify if the board may take action in lieu of a meeting by use of a written consent. Some states allow board action by less than unanimous consent if the articles or the bylaws contain a provision allowing for it. If appropriate under state law, an organization can consider e-mail to be acceptable for taking a written consent, but the e-mail consent will need to meet the requirements for an electronic signature – an e-mail string may not be sufficient.

The bylaws should specify the quorum and state the number of votes for the board to take action. This is generally the majority of directors present, but the bylaws may contain a provision requiring a higher standard (the majority of directors in office; two-thirds of the directors in office) for certain actions, such as amendments to the bylaws.

II. **Fiduciary Duties**

A. Duty of Care.

A director must act in good faith. MNCA §8.30(a)(1). Compliance with the fiduciary duty of care requires that the director makes decisions on a fully informed basis. This includes:

i. Making reasonable inquiries, actively obtaining all material facts reasonably available and pursuing all reasonably available sources of information or knowledge (e.g., discussing the matter with officers of the organization as well as independent advisors retained by the organization, including outside legal counsel and financial advisors) to make an informed decision.

director may even be present at or participating in the meeting of the board that authorizes the contract) if:

i. The conflict is disclosed and the board in good faith authorizes the contract by the affirmative votes of a majority of the disinterested directors (even though the disinterested directors are less than a quorum).

ii. The conflict is disclosed and the members specifically approve the contract; or

iii. The contract or transaction is fair to the corporation as of the time it is authorized, approved, or ratified by the board or the members.

Conflicts of interest that should be disclosed include:

i. Facilitating a transaction in an attempt to curry favor with the proponent of the transaction, other members of the board or members of management.

ii. Usurping corporate opportunities for the director's personal benefit; the organization must be given the first opportunity to take advantage of all opportunities within its line of business or in which the organization has an interest or a reasonable expectation of having an interest.

iii. Deriving an unfair or secret profit or commission from the director's position as a director at the expense of the organization.

iv. Receiving additional compensation or enhanced career prospects as a result of a transaction.

The IRS has a sample conflict of interest policy which requires much more than just disclosure. In general, under the IRS conflict of interest policy, if a conflict exists, the director must recuse himself/herself from not only the vote on the matter but also from the discussion (*i.e.*, leave the room). The IRS conflict of interest policy follows the requirements under the excess benefit rules.

Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, 381 F. Supp. 1003 (D.D.C 1974) is an example of the application of conflict of interest and investment diligence. The organization's directors had not attended meetings and had left large amounts in non-interest bearing accounts in a bank with which one of the directors was affiliated. The court set forth standards that are instructive. The court held that the director had violated his fiduciary duty to manage the fiscal and investment affairs if the evidence shows that (a) as a member of a board committee with general financial or investment responsibility, the director failed to use diligence in supervising the actions of those to whom day-to-day responsibilities for making financial or investment decisions has been delegated; (b) the director knowingly permitted the organization to enter into a transaction with himself, or a business with which he was associated, without having informed the organization of his interest or that the transaction might not be in the best interests of the organization; (c) except for such disclosure,

evidence that the director, in reaching the challenged decision, breached the duty of care, the duty of loyalty or the duty of obedience.

F. Standards of Liability for Directors

Under MNCA §8.31, a director is generally not liable to the nonprofit corporation or its members for any decision to take or not to take action, or any failure to take any action, as a director. The general exceptions are:

i. An action not in good faith; or

ii. A decision:

   a. which the director did not reasonably believe to be in the best interests of the corporation, or

   b. as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances; or

iii. A lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence due to the director's domination or control by, another person having a material interest in the challenged conduct:

   a. which relationship or which domination or control could reasonably be expected to have affected the director's judgment respecting the challenged conduct in a manner adverse to the corporation; and

   b. after a reasonable expectation to such effect has been established, the director has not established that the challenged conduct was reasonably believed by the director to be in the best interests of the corporation; or

iv. A sustained failure of the director to devote attention to ongoing oversight of the activities and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefor; or

v. Receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its members that is actionable under applicable law.

G. Directors' Liability for Unlawful Distributions / Loans

Directors are liable for unlawful distributions for the amount of the distribution that exceeds what could have been lawfully distributed if the director did not meet his duty of

financial benefit to which the director was not entitled, whether or not involving action in an official capacity.

MNCA §8.51. In order to indemnify a director under MNCA §8.51, the board has to make a determination that the director has met the required standard. MNCA §8.55.

D. Indemnification of Officers

Officers are generally allowed the same indemnification as directors. The articles of incorporation, bylaws, or resolution of the board of directors may direct the nonprofit corporation to further indemnify the officers, except for any:

i. Liability in connection with a proceeding by or in the right of the corporation other than for reasonable expenses incurred in connection with the proceeding, or

ii. Liability arising out of conduct that constitutes:

   a. receipt by the officer of a financial benefit to which the officer is not entitled;

   b. an intentional infliction of harm on the corporation or the members; or

   c. an intentional violation of criminal law. MNCA §8.56.

E. Directors and Officers Liability Insurance (D&O Insurance).

Indemnification is not useful if the organization does not have the cash to pay the indemnification to the directors and officers. D&O insurance is a must. However, D&O insurance is more notable for what it does not insure than for what it does insure. Essentially, the typical policy covers fiduciary liability to the organization itself, i.e., loss of funds, rather than third-party liability for such things as personal injuries. Look carefully at the policy exclusions section to determine if you are receiving the desired coverage. D&O Insurance is desirable to make sure that some insurance company covers the costs of defense, which may exist even if no liability is established, to cover any indemnification obligations that the corporation may have to a sued director under its governing documents or state law, and to assist in the recruitment of directors.

A major issue for D&O insurance is covering private foundation excise taxes and "excess benefit" excise taxes. For excise taxes to be imposed on a director or officer, the individual must have acted knowingly, willfully and without reasonable cause. State insurance laws do not permit an insurance company to pay insurance for actions that were taken knowingly and in willful violation of the law. Therefore, if tax is imposed, the insurance company cannot pay the excise tax imposed on the officer or director. However, D&O insurance can pay the defense costs, regardless if the defense is successful or unsuccessful. For claims that are successfully defended or settled, insurance coverage is very valuable (although it may not pay the ultimate tax if one is imposed).