

DUTIES OF NON-PROFIT DIRECTORS

To deal with bad management in the commercial world, God created shareholders. In the non-profit world, however, when management stumbles, steals, or simply loses focus, who can call management to account? Must the key stakeholders in a non-profit – beneficiaries, employees and funders – persevere, Job-like, in despair of salvation from lousy management? Often, the answer is yes, unless the board of directors of the non-profit oversees the organization with a zeal that exceeds the minimum legal standard imposed on boards of directors. This means that a non-profit board not only has to measure up to the common law standard of fiduciaries (about which more later), and not only has to insure compliance with IRS rules (more later on that, too), but it must also, in the person of at least one, but ideally many, independent board members, bring passion to the job of oversight.

In that order – fiduciary, IRS and passion -- let's define the job of non-profit boards.

In the past, courts held non-profits to the standard of care of a common law trust fiduciary. Under that so-called trust fiduciary standard, a trustee of a trust is liable for losses occasioned by mere negligence, meaning, as one expert put it, that the trustee pays for losses “even though he does the best he can.”¹ To the well intentioned but unlucky trustee, good faith is not good enough and reasonable behavior is not reasonable enough.

The trust fiduciary standard of conduct was originally intended for, and still applies to traditional private trusts charged with managing investment assets. However, even in the Dickensian days of single-benefactor funded, volunteer-staffed poor houses, the rigid, all or nothing trust fiduciary standard of care was a poor fit for those charged with the active management of a charitable organization. Budgets, employees, fundraising and program implementation require independent judgment. Independent judgment, in turn, only occurs when it is arrived at free of fear from second-guessing.

¹ Scott, *The Law of Trusts* § 201, at 220 (4th Ed. 1988).

Practices and expectations have evolved to the point where the standard of care for the board of a non-profit resembles that of a for-profit board. Courts “cannot second-guess the wisdom of facially valid decisions made by charitable fiduciaries any more than it can question the business judgment of the directors of a for-profit corporation.”² The starting point, therefore, for the agency obligations of directors to a non-profit are the rules applicable to directors of a for-profit enterprise.

In the for-profit world, directors, even those employed by the organization, are expected to exercise independent judgment “on behalf of the organization.” The notion of acting in the interest of another – agency, in a word – is as fundamental to the functioning of organizations as the wheel is to the functioning of modes of transportation. Exercising independent judgment on behalf of an organization means addressing issues that come before the governing body in a way that advances the interests of the organization, rather than the interests of the directors or the interests of any other party.

The agents, the officers and directors of a for-profit corporation, owe a duty of care and a duty of loyalty to the corporation. Got it? Duty of *care*. Duty of *loyalty*.

Duty of Care:³ In discharging the obligation to bring due care to board deliberations, the actions of directors are judged against the “business judgment rule.”⁴ Under the business judgment rule, a party acting in good faith and with a reasonable belief that his or her actions are appropriate will not be held responsible for an undesirable outcome.⁵ The Model Non-Profit Corporation Act (non implemented in Maryland) provides that this standard is “intended to protect the directors who innovate and take informed risks to carry out the corporate goals and objectives . . . Directors are not guarantors of the success of investments, investments, activities, programs or grants.”⁶

² Kirby v. Oberly, 592 A.2d 445, 462 (Del. 1991).

³ Corporations and Associations §2-405.1

⁴ Dencla and Stern v. Lucy Webb Hayes.

⁵ Model Non-Profit Corporation Act, Section ____

⁶ Model Non-Profit Corporation Act, Section 8.30, Comment 2.

The duty of care, intertwined as it is with this formulation of the business judgment rule, is not so much a substantive obligation as one of procedure. Rather than judging a board by whether it got the right answer, the relevant questions are: Were all of the directors free of conflicts of interest in reaching the decision in question? Did they insist on data? Was it reasonable to rely on the data provided, and on the sources consulted for advice on the question?

An examination of instances where non-profit boards have run afoul of the duty of care standard reflects the essentially procedural nature of the obligation. These examples also underscore the idea that satisfactory compliance with this standard lies very much within the control of each director.

A fundamental duty of a director is to keep informed about the business of the organization. In a suit against a director of a commercial firm that unexpectedly filed for bankruptcy, the director claimed that he wasn't responsible for the firm's demise because he hadn't kept track of its finances. The court rejected that defense, stating that, having "accepted a post of confidence [the director] was charged with a duty to learn."⁷ A director need not keep track of every detail, the court reasoned, but he or she should stay informed about an organization's mission, its conformity with that mission and its financial condition.

That last category, the money thing, is a big deal. In another case, directors of the Lucy Webb Hayes National Training School for Deaconesses and Missionaries had to pony-up for lost interest earnings after it was discovered that the chief financial officer of the organization had allowed millions of dollars to sit in a non-interest bearing checking account for years.⁸ Notice that there was no dishonesty, only incompetence. And notice that the foul-up didn't even involve the organization's core function or mission. The bottom line? If the law won't cut some slack for deaconesses and missionaries, it won't cut any for you.

⁷ Barnes v. Andrews, 298 F. 614 (S.D.N.Y.).

⁸ Stern v. Lucy Webb Haynes National Training School for Deaconesses and Missionaries, 31 F. Supp. 1003 (D.D.C. 1974).

Faithful discharge of the obligations of an agent calls for more than merely putting the interests of the principal first; it requires focus and concern.

Related to the obligation to stay informed is the duty to attend board meetings. Attending board meetings demonstrates responsibility and diligence. Recall the guy who got sued for not paying attention to company finances as it slid into bankruptcy. Not attending meetings guarantees that you will miss the indicators of trouble.

The duty to stay informed also raises the question of whether mere attendance at board meetings and the mere passive receipt of information constitute a satisfactory level of care. At a minimum, directors should insist on reporting processes that ensure that all relevant information is being provided to them, and provided on a timely basis. “Directors must assure themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely accurate information sufficient to allow management and the board ... to reach informed judgments.”⁹

Satisfying the duty to stay informed on a routine basis requires attention to systems and reporting protocols. Here is an example: Don’t serve on the board of a non-profit that handles any kind of serious money if it doesn’t have an independent outside accountant helping with the books. Insist, furthermore, on an audited statement from that outside accounting firm if possible (try getting a foundation or government grant without an audited statement) and, if not, either regular face time with the CPA or some sort of regular outside reporting appropriate to the size, sophistication and resources of the organization.

And what use, pray tell, should diligent members make of this independently sourced information? In an embarrassing example of a board of directors sleeping through the best parts, directors were accused in one case of allowing management to expend funds in excess of projected revenues, failing to insure contract compliance by customers and failing to

⁹ In re: Caremark International, Inc., 698 A.2d 959, 970 (Del. Ch. 1996).

establish effective controls and to adhere to budgetary constraints.¹⁰ Could the board have made a worse hash of things? Yes, if, as occurred with another organization that had to sell its building to satisfy unpaid payroll taxes, the IRS asserts liability against board members who, after being alerted by the organization's auditor, continue to tolerate an executive director who fails to remit payroll tax withholdings to the IRS.

The lesson? Sometimes managers at smaller non-profits, despite even the best of intentions, are not up to the task of managing the business side of operations. Less frequently, but often enough to worry, managers have other reasons – dishonesty, ego, internal politics – for not doing the right thing. A review of budgeted and actual revenues and expenses should therefore appear as a board agenda item on a regular basis *and* at least one outside director should be tasked with really figuring out in real time how the finances of the organization are faring. In addition, if the organization fails to remit payroll tax withholdings to the IRS for a quarter, board members must either intervene aggressively or run for the hills.

Staying informed takes on a heightened importance when a board is asked to actually decide something: to buy or sell something important or to undertake a large obligation of some kind. The board needs to be actively involved in the decision. It should insist that relevant documents be distributed in advance of meetings, so the board members can digest and fully consider the question.

So where does that leave us? The directors of a non-profit have to stay informed about whether too much money is being parked in a non-interest bearing checking account. They have to worry about whether the executive director is being paid too much. They have to worry about budgets, and whether budgets are being followed. It can seem serious -- forbidding, even -- perhaps more than a volunteer director bargained for.

The solution, such as it is, is the ability, and the right, to reasonably rely on others. Recall that, under the business judgment rule, a party acting with a "reasonable belief" that his or her actions are appropriate will not be held responsible for an undesirable outcome.

¹⁰ Louisiana Weld Expedition v. Federal Insurance Co., 858 F. 2d 233 (5th Cir. 1988).

That critically important reasonable belief can derive from the judgment and competence of consultants, board committees and, often, of managers of the organization.

Legally, it's a crucial point. If I have the corner garage mechanic fix the brakes on my car, and then I run a red light because the brakes don't function I am still liable for an accident caused by my running the red light, even though it wasn't my fault that the brakes didn't work. Why? Because I have a non-delegable duty to drive with functioning brakes. In contrast, in the world of legal entities –for-profit and a not-for-profit alike -- directors may delegate fact-finding, and may delegate matters of judgment requiring specialized knowledge in discharging their duty of care. Indeed, as the context requires, such as with valuation issues and accounting methodologies, a director's duty of care requires reliance on the expertise of others.

It is generally reasonable to rely on information provided by officers and employees of a corporation, provided the directors reasonably believe them to be reliable and competent in the matters presented. They can also rely on legal counsel (again, when the directors reasonable believe the matters within that lawyer's professional competence) or a committee of the board of which a given director is not a member. In addition, in the case of religious organizations, board members can rely, where appropriate, on the authority of clergy.

Examples of when board members should consult outside valuation experts include the purchase or sale of significant assets, an agreement to engage an outside party to provide significant services and the appropriate salary for a high executive. At a minimum, one or more board members should be charged with researching the availability of data on comparable transactions. The emphasis is on sound process. If an organization can't afford, for example, a compensation consultant to assist in negotiating an employment contract for an executive directive, there are a variety of databases available for research on the internet.**[list]** the reasonableness of reasonable due diligence means reasonable given the resources available. It is not uncommon for the board of a nonprofit to get in trouble, either with courts or discomfited funders, for agreeing to excessive compensation to high

executives.¹¹ Consequently, decisions about the salary of all the top earners in an organization must be papered with either a report from an outside consultant or, minimally, with evidence some contemporaneous research on comparable salaries.

A case involving an innocent and well-intentioned payment to a religious order suggests where the boundary lies between decisions protected by the business judgment rule and those bad business decisions which subject directors to liability. The board of directors of a hospital agreed to make a substantial payment to the members of a religious order in consideration of many years of service provided by the religious order to the hospital.¹² The court ruled that, as the hospital had no legal obligation whatsoever to make the payment, the decision to do so was not a proper exercise of sound business judgment.

The decision is, on first blush, jarring, in that one could justify the payment as the “charitable thing to do,” given the years of loyal support by the religious order and the absence of any conflict of interest on the part of any directors. With a clearminded understanding of the directors’ fiduciary obligation to the hospital, however, the board could have paid the money without violating its duty of care. For example, the board could have agreed to the payment as part of an arrangement for future services by the religious order. In addition, depending on the articulated mission of the hospital, there might well have been a justification for making the payment based on the particulars of that mission. Good lawyering, as always, could have saved the day.

The lesson, therefore, is not to be scared off by formal demands of serving on a non-profit board, but rather to insure sufficient understanding of those demands to serve as a foundation for reaching decisions which the board, in good faith, believes to be consistent with the goals of the organization

Duty of Loyalty [insert] note: applies equally where business deal is with another nonprofit. For example, if organization A appoints the board members of organization B, the

¹¹ In re: Heritage Village Church and Missionary Fellowship, 92 B.R. 1000 (D.S.C. 1988).

¹² Queen of Angels Hospital v. Younger, 132 Cal. Rptr. 36 (Ct. App. 1977).

B board members who serve on A's board can't vote on matters coming before the A board that affect B (true?)

Special Liability Rules Applicable to Nonprofits In addition to these off the shelf provisions, directors, officers, trustees, employees and volunteers of certain organizations are not liable for damages if the following conditions are met: (i) the party in question has not acted with either "malice or gross negligence."¹³ and (ii) the organization has a certain minimum level of insurance coverage.

¹³Courts and Judicial Proceedings §5-406(b)(d)

The insurance contract must by its terms provide coverage for the act or omission which is the subject matter of the suit. Minimum coverage limits are \$200,000 per individual claim and \$500,000 for total claims from the same occurrence. Alternatively, the coverage can provide for \$750,000 per policy year, and \$500,000 per total claims that arise from the same occurrence. The maximum deductible is \$10,000 per occurrence.

If the limitations on liability apply, the plaintiff's maximum recovery from the *organization* is the applicable insurance coverage limits (plus the deductible). These limits do not apply to suits brought by the government involving willful violations of various statutory fund-raising requirements found in Title 6 of the Business Regulation Article of the Maryland Code.¹⁴

Regarding volunteers, a volunteer's liability is limited to his or her own personal insurance limits. These limits don't apply to actions or omissions constituting gross negligence, reckless, willful or wanton misconduct, or intentionally tortious conduct. The limits also do not apply if the claim arises from the act or omission of another volunteer or an officer or other agent of the organization, and the volunteer in question knew or should have known about the wrongful act or omission, but in some fashion either authorized, participated in or approved of it.[example]

[Sarbanes Oxley]

[Intermediate sanctions]

¹⁴Courts and Judicial Proceedings §5-406(e)