

Current Practices Regarding Governance and Director Liability

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Attorneys advising nonprofits and their boards of directors must be aware of both the legal norms governing their conduct and the operative public perceptions concerning not-for-profits and their boards. Mindful of the frequent inconsistencies in these bodies of information, this presentation discusses a series of practical measures that will help organizations and their boards to avoid liability and even the appearance of conflicts of interest or other questionable conduct. Thus, this outline will discuss the basic state and federal laws governing the not-for-profit director and the types of conduct and practices that facilitate appropriate governance behavior by the board. It will also discuss limitations on director liability, as well as indemnification and director and officer liability insurance.

I. The Legal Duties of Not-for-Profit Officers and Directors

Officers and directors are considered fiduciaries of the not-for-profit organizations they manage. Scheuer Family Foundation, Inc. v. 61 Associates, 179 A.D.2d 65, 582 N.Y.S.2d 662 (1st Dept. 1992); Billings v. Shaw, 209 N.Y. 265, 282, 103 N.E. 142, 148 (1913). Their fiduciary duties of care and loyalty, derived from common law, are articulated in the New York Not-for-Profit Corporation Law (“N-PCL”).

A. The Duty of Care

Nonprofit directors and officers owe the organization on whose boards they serve a duty of care, articulated in Section 717 of the N-PCL as follows:

Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

1. This language is adopted from the for-profit corporate law; the duty of care of for-profit officers and directors is described in virtually identical language in Business Corporation Law §§ 715(h) and 717.
2. As at least one commentator has observed, this language is too general and nebulous to be a helpful guide to director and officer conduct. See Fishman, “Standards of Conduct for Directors of Nonprofit Corporations,” 7 Pace L. Rev. 389, 393 (1987) (hereinafter “Fishman”).
3. However, N-PCL § 717 does suggest that the board members must “understand the business of the company of whose board they sit.” Spitzer v. Grasso, 236 NYLJ 80 (NY Supreme Court 10/18/06). The board must conscientiously decide the matters that come before it, create and enforce “internal information systems” and “serve as a check or veto on management.” Fishman at 393.
 - a. This standard allows directors considerable leeway and discretion in the discharge of their responsibilities. Note, “The Fiduciary Duties of Loyalty and Care Associated with the Directors and Trustees of Charitable Organizations,” 64 Va. L. Rev. 449, 453-454 (1978).
 - b. On its face, the statutory language articulating the duty of care suggests that directors will be found to have breached the duty upon a finding of negligence.

However, the Court of Appeals has recently applied the business judgment rule to a New York not-for-profit corporation. See Consumers Union of U.S. v. New York, 5 N.Y.3d 327 (2005), dismissing a claim of breach of fiduciary duty against the board of a not-for-profit organization that converted to for-profit status on the basis, inter alia, that the business judgment rule barred judicial inquiry into actions of corporate directors taken in good faith, citing Auerbach v. Bennett, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920, 925 (1979).

- c. The propriety of applying the business judgment rule in the not-for-profit context was questioned in Judge G.B. Smith's dissent in the Consumers Union case; he argued that application of the business judgment rule in the nonprofit context "weakens the accountability of corporate directors" and "annuls the fiduciary obligations of not-for-profit directors for no good reason." No. 83, 2005 N.Y. Lexis at 1433 * 70-71. See also Note, "The Business Judgment Rule: Should it Protect Nonprofit Directors?," 103 Colum. L. Rev. 925 (May 2003) (arguing that ordinary negligence standard, rather than business judgment rule, should apply).
- d. In suits by third parties, as opposed to suits by the corporation itself, many states have limited liability to instances involving gross negligence or intentional harm. See, e.g., N-PCL § 720-a.
- e. The interplay between the duty of care and the board's authority to expend endowment funds exceeding the "historic dollar value" of those funds, articulated in N-PCL Section 513(c) is the subject of an advisory posted on

the Charities Bureau website. It points out that section 717(a) requires the board to “consider among other relevant considerations the long and short term needs of the corporation in carrying out its purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.” In general, it cautions boards to formulate prudent spending policies that do not unduly deplete endowment assets.

B. The Duty of Loyalty

The duty of loyalty requires a director to pursue the interests and mission of the not-for-profit with undivided allegiance. However, beyond N-PCL § 717(a)’s reference to discharge of directorial duties “in good faith,” there is no statutory formulation of the general duty of loyalty. One must look to case law for an articulation of the standard under New York law.

1. To satisfy the duty of loyalty, directors must “subordinate their individual and private interests to their duty to the corporation.” Nechis v. Gramatan, 231 N.Y.S.2d 383, 35 Misc.2d 949 (Sup. Ct. Westchester County 1962), quoting Winter v. Anderson, 242 A.D. 430, 275 N.Y.S. 373 (4th Dept. 1934).
2. They also are prohibited from utilizing their fiduciary position to usurp a business opportunity or advantage available to the corporation. This “corporate opportunity doctrine” has been described as follows:

[I]f there is presented to a corporate officer or director a business opportunity ... in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be

brought into conflict with that of [the] corporation, the law will not permit [the officer or director personally] to seize the opportunity....

Robinson v. R & R Publ'g, Inc., 943 F.Supp. 18 (D.D.C. 1996), quoting Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503, 511 (Del. 1939). See also American Baptist Churches of Metro. N.Y. v. Galloway, 271 A.D.2d 92, 710 N.Y.S.2d 12 (1st Dept. 2000); Bolton v. Stillwagon, 410 Pa. 618, 190 A.2d 105 (1963), Fishman at 431-432.

3. One particular type of self-dealing conduct – loans from the not-for-profit to an officer or director – is explicitly prohibited by N-PCL § 716.
4. The duty of loyalty does not bar all transactions between a director and the not-for-profit. Section 715 of the N-PCL allows these “interested party transactions” under certain specified circumstances.
 - a. The directors’ or officers’ interest in the transaction must be fully disclosed to the board or be known by them and the transaction must be authorized by a vote of “disinterested” board members, i.e., a majority of the board that does not include the vote of the interested director. N-PCL § 715(a)(1).
 - b. In a membership organization, the transaction may be authorized by a vote of the members, if the material facts of the interest are disclosed to the members or known to them. N-PCL § 715(a)(2).
 - c. Interested officers and directors can be present at a meeting at which approval of the transaction in which they have an interest is considered, and they can be counted in determining the presence of a quorum at such meeting. N-PCL § 715(c).

- d. The interested party transaction may still be binding on the corporation even in the absence of the required disclosure and in the absence of a vote of disinterested board members, as where the interested director's vote was necessary for the authorization of the transaction. Under those circumstances, the parties to the transaction must "establish affirmatively that the contract or transaction was fair and reasonable as to the corporation..." N-PCL § 715(b).

C. Internal Revenue Code Rules Relating to Conduct of Fiduciaries

The Internal Revenue Code ("IRC") also prohibits acts of self-inurement and self-dealing for tax-exempt organizations. IRC § 501(c)(3) requires that every 501(c)(3) organization be operated exclusively for tax-exempt purposes and that "no part of [its] net earnings ... inures to the benefit of any private shareholder or individual..." While this prohibition affects individuals other than directors and officers, in practice, these rules have the most direct bearing on those charged with the governance of not-for-profit organizations.

1. Rules for Public Charities

IRC § 4958 proscribes "excess benefit transactions" between certain charitable organizations and "disqualified persons" (generally, those in a position to exercise "substantial influence" over the organization). This section gives the Internal Revenue Service the authority to impose penalty taxes (known as "intermediate sanctions," in

contrast to the ultimate sanction, revocation of exempt status) when a transaction is found to bestow an excess benefit on a disqualified person.

a. Definition of Excess Benefit. An excess benefit transaction is one in which the economic benefit provided to the disqualified person is greater than the return benefit to the applicable tax-exempt organization. IRC § 4958(c)(1)(A). In short, the deal is lopsided in favor of the disqualified person. Such transactions include unreasonable compensation paid to a disqualified person, including reimbursement for expenses, and sales of property to disqualified persons for less than the fair market value of such property. See P.L.R. 200247055 (Nov. 22, 2002) (no excess benefit found where benefit to physicians who were disqualified persons from hospital's free bus service does not exceed benefits to public generally); P.L.R. 200421010 (Feb. 20, 2004) (sharing of expenses for employees, office space, and equipment not an excess benefit transaction where based on detailed allocation records as to the various expenses); P.L.R. 200335037 (June 2, 2003) (nonprofits' grants which raise a bank's rating under the Community Reinvestment Act of 1977 did not confer an economic benefit on the bank and thus did not constitute excess benefit transactions).

- 1) The excess benefit rules will not apply to fixed payments made pursuant to an initial contract. Thus, for example, the initial contract of an organization's CEO will not be subject to the excess benefit transaction rules. This is sometimes referred to as the "first bite" exception. Treas. Reg. § 53.4958-4(a)(3).

- 2) Both direct and indirect economic benefits, e.g, benefits provided to a disqualified person through a controlled entity or an intermediary, may be considered excess benefit transactions. Treas. Reg. § 53.4958-4(a)(2).
- 3) Under new rules contained in the Pension Reform Act, the definition of an excess benefit transaction is expanded for supporting organizations, so that intermediate sanctions may be imposed if a supporting organization makes a grant, loan, payment of compensation or similar payment to a substantial contributor, or a related person, of the supporting organization. The entirety of the prohibited payment is subject to the excise tax. Public charities, other than another supporting organization, are also excluded from the definition of disqualified person for this purpose.

These rules apply retroactively to transactions occurring after July 25, 2006.

- b. General Definition of Disqualified Person. A “disqualified person” is one who, at any time during a five-year “lookback” period prior to the transaction, was in a position to exercise substantial influence over the organization. Voting members of the governing body, presidents, chief executive officers, chief operating officers, and chief financial officers are presumed to have substantial influence. Treas. Reg. § 53.4958-3.

- 1) In addition, the following family members of those in positions of substantial influence are also considered to be disqualified persons: spouse, ancestors, children, grandchildren, great-grandchildren, spouses of children, grandchildren and great-grandchildren, brothers and sisters and their spouses.

IRC § 4958(f)(4). (Note that for private foundations, the list of family members deemed to be disqualified persons by virtue of their relationship excludes the siblings, and their spouses, of the disqualified person.)

- 2) Entities as well as individuals can be disqualified persons. An entity where 35% of the control is held by a disqualified person is itself a disqualified person. Treas. Reg. § 53.4958-3(a)(2).
 - 3) The determination of whether a person (including an entity) is in a position to exercise substantial influence over the organization is measured by the person's actual powers and duties and not by title alone. The IRS evaluates all the relevant facts and circumstances in determining whether an individual has substantial power or influence. Treas. Reg. § 53.4958-3(e).
 - 4) Non-profit organizations exempt under IRC § 501(c)(3) are deemed not to be disqualified persons, and organizations exempt under IRC § 501(c)(4) are deemed not to be disqualified persons with respect to other IRC § 501(c)(4) organizations. Treas. Reg. § 53.4958-3(d).
- c. Excise Taxes. The penalty for engaging in an excess benefit transaction is a tax on the disqualified person, not on the organization.
- 1) The initial tax is equal to 25% of the excess benefit. If the excess benefit is not corrected within a reasonable time, an additional tax equal to 200% of the excess benefit will also be imposed. IRC § 4958(a)(1), (b).
 - 2) Organization managers may also be subject to penalty taxes in cases where a tax is imposed on a disqualified person and the manager(s) knowingly

participated in the transaction, and such participation was willful and not due to reasonable cause (such as reliance upon a written opinion of counsel). IRC § 4958(a)(2). The tax on organization managers is 10% of the excess benefit, up to a maximum total of \$20,000 per transaction. (Prior to the passage of the Pension Reform Act, the transaction cap was \$10,000.) IRC § 4958(d)(2).

d. Safe Harbor Procedures. The regulations contain a set of procedures that, if followed when approving a transaction between a disqualified person and the organization, will afford the disqualified person the benefit of a rebuttable presumption that the transaction was reasonable. If the transaction is a compensation arrangement, a rebuttable presumption will be created that the compensation is reasonable, and if the transaction is a transfer of property, a rebuttable presumption will be created that the transfer is at fair market value. This presumption shifts the burden of proving that the transaction was unreasonable (and thus subject to intermediate sanctions) to the IRS. Treas. Reg. § 53.4958-6. It is highly recommended that all non-profit organizations take advantage of the protection the safe harbor provisions offer. The procedures are as follows:

- 1) The decision about the transaction must be made in advance by the board (or an authorized committee thereof), composed entirely of individuals who do not have a conflict of interest with respect to the transaction and, thus, are truly “disinterested.” Treas. Reg. § 53.4958-6(a)(1).
- 2) The Board or committee must have obtained and relied upon appropriate comparability data in making its decision. Appropriate data as to

comparability may include appraisals, other offers or, in the case of compensation decisions, this data can include documented compensation levels of persons working in similar positions in similar organizations. (Similarities of size and geographic location are among the factors considered.) The Board can also look to reliable surveys of compensation levels and expert studies. Treas. Reg. § 53.4958-6(a)(2). See P.L.R. 200244028 (June 21, 2002) (no rebuttable presumption created where minutes of meeting approving compensation failed to substantiate board reliance on compensation study and where compensation study was done after meeting). Organizations with less than \$1 million a year in gross receipts need only rely on comparability data from three other organizations. Treas. Reg. § 53.4958-6(c)(2).

- 3) The disqualified persons, or those for whom the transaction presents a conflict of interest, may meet with other members to answer questions, but may not be present during debate and voting on the transaction. Treas. Reg. § 53.4958-6(c)(1)(ii).
- 4) The board or committee must document the basis for its decision within 60 days of the action taken, or before their next meeting. The documentation must include: a) the terms of the transaction and the date approved; b) the members of the board, or committee, who participated in the discussion and who voted on it; c) the comparability data relied upon and how it was compiled; and 4) the actions of any member of the board or committee having

a conflict of interest with respect to the transaction. Treas. Reg. § 53.4958-6(a)(3), (c)(3).

Consistent with the intensified interest in conflicts of interest, the Internal Revenue Service has revised the Form 1023 in order to “streamline the application process for the organizations and [to] help the IRS spot potential abusive charities.” See <http://www.irs.gov/pub/irs-pdf/f1023.pdf>. Part V of the new Form 1023 requests information about compensation to directors, officers, trustees, as well as compensated employees and independent contractors. In addition, the Form 1023 asks for a description of the organization’s conflicts of interest policies and whether transactions with officers, employees and contractors are negotiated at arm’s length.

2. Rules for Private Foundations

Organizations which are classified as private foundations by the Internal Revenue Service (generally, organizations which derive their support from one or more related individuals) are subject to special, stringent rules concerning transactions between them and the disqualified persons. With limited exceptions, these rules prohibit these so-called “self-dealing” transactions between disqualified persons and the private foundation, regardless of the benefit (or lack thereof) to either party, and impose excise taxes for violations of these rules. IRC § 4941.

- a. **Definition of Disqualified Person.** Although the term “disqualified person” is also used in connection with excess benefit transactions, it is defined somewhat differently in the private foundation context.

- 1) For purposes of the self-dealing rules, disqualified persons are defined as follows: a) substantial contributors to the foundation (typically the founder and other major donors); b) foundation managers (typically directors and officers); c) an owner of more than 20% of the voting power, profits interest or beneficial interest of a corporation, partnership or trust, respectively, that is a substantial contributor to the foundation; d) the spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of children, grandchildren and great-grandchildren of a person described in a), b) or c), above; and e) entities in which disqualified persons own more than 35% of the equity, voting power, or beneficial interests. IRC § 4946(a).
 - 2) Note that the siblings (and their spouses) of disqualified persons are not considered disqualified persons in the self-dealing context, whereas they are for purposes of the excess benefit transaction rules.
 - 3) Only those individuals or entities meeting the technical definition are considered disqualified persons, in contrast to the excess benefit transaction context, where any individual or entity that is in a position to exercise substantial influence will be considered a disqualified person.
- b. Definition of Self-Dealing Transaction. The following transactions (whether direct or indirect) between a private foundation and a disqualified person are acts of self-dealing and are strictly prohibited, with certain very limited exceptions. IRC § 4941(d)(1).

- 1) The sale, exchange or leasing of property between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(a), (b).
 - 2) A loan or other extension of credit between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(c).
 - 3) The furnishing of goods, services or facilities between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(d).
 - 4) The payment of compensation, including reimbursement of expenses, by a private foundation to a disqualified person. Treas. Reg. § 53.4941(d)-2(e).
 - 5) The transfer of a private foundation's income or assets to or for the benefit of a disqualified person, including the use of such assets by the disqualified person. Treas. Reg. § 53.4941(d)-2(f).
 - 6) The agreement by a private foundation to make payments of money or other assets to a government official. Treas. Reg. § 53.4941(d)-2(g).
- c. Exceptions to the Self-Dealing Rules: Although the rules cited above are per se prohibitions, the exceptions limit their negative impact to some extent, as they encompass some of the most benign transactions between disqualified persons and the private foundation:
- 1) The leasing of property by a disqualified person to a private foundation without charge does not constitute self-dealing, even when the private foundation pays for the basic maintenance costs it incurs in relation to its use of the property (as long as the payment is not made directly or indirectly to the disqualified person). Treas. Reg. § 53.4941(d)-2(b)(2).

- 2) The lending of money, or extension of credit, to a private foundation by a disqualified person is not an act of self-dealing as long as no interest or other charge is involved. Treas. Reg. § 53.4941(d)-2(c)(2).
- 3) It is not an act of self-dealing for a disqualified person to furnish goods, services or facilities to a private foundation without charge. For purposes of this exception, the private foundation can pay for transportation, insurance and maintenance costs associated with its use of the property or services, as long as the payment is not made directly or indirectly to the disqualified person. Treas. Reg. § 53.4941(d)-2(d)(3).
- 4) It is not an act of self-dealing for a private foundation to furnish goods, services or facilities to a disqualified person so long as they are made available to the general public on as least as favorable terms. Treas. Reg. § 53.4941(d)-3(b)(1).
- 5) It is not an act of self-dealing for a private foundation to pay compensation to a disqualified person for personal services rendered that are reasonable and necessary to carry out the exempt purposes of the foundation, as long as the compensation is not excessive. This exception does not apply to government officials. Treas. Reg. §§ 53.4941(d)-2(e), 53.4941(d)-3(c)(1).
- 6) A disqualified person can receive incidental benefits from a private foundation's use of its income or assets without running afoul of the self-dealing rules. For example, if a private foundation gives public recognition to a disqualified person who has been a substantial contributor to the foundation,

this benefit is viewed as incidental and, thus, is not an act of self-dealing.

Treas. Reg. § 53.4941(d)-2(f)(2).

7) The “First-Bite” Exception. Self-dealing does not include a transaction between a private foundation and a disqualified person where the disqualified person status arises as a result of the transaction. For example, if a person sells property to a foundation at a bargain price and, as a result of this transaction becomes a substantial contributor (and, thus, a disqualified person) as a result of the transaction, this “first-bite” transaction will not be considered an act of self-dealing. Treas. Reg. § 53.4941(d)-1(a). However, the person who became a substantial contributor by virtue of this transaction will be treated as a disqualified person going forward.

8) Transactions During Estate Administration. Fair market value sales and exchanges that occur as part of the administration of an estate of which the private foundation is a beneficiary are not acts of self-dealing but are subject to court approval. Treas. Reg. § 53.4941(d)-1(b)(3).

d. Excise Taxes. The penalty for engaging in an self-dealing is a tax on the self-dealer and foundation managers, not on the organization.

1) Tax on the Self-Dealer. Prior to the enactment of the Pension Reform Act, an initial tax equal to 5% of the amount involved in the act of self-dealing was imposed on any disqualified person (other than a foundation manager acting only in that capacity) who participated in the act; the Act raised the initial tax rate to 10%, effective for taxable years beginning after the date of enactment.

Except in the case of government officials, the tax will be imposed even when the disqualified person had no knowledge at the time of that act that it constituted self-dealing. IRC § 4941(a)(1). A disqualified person is considered to have “participated” in an act of self-dealing even in instances where he directed another person to engage in the transaction. Treas. Reg. § 53.4941(a)-1(a)(3). If the act of self-dealing is not “corrected” (generally, undoing the transaction or returning the private foundation to at least the financial position it would have been in absent the transaction) in a timely fashion, an additional tax of 200% of the amount involved is imposed upon the disqualified person. IRC § 4941(b)(1).

- 2) Tax on Foundation Managers. Prior to the passage of the Pension Reform Act, an initial tax equal to 2.5% of the amount involved in the act of self-dealing was imposed on foundation managers who participate in an act of self-dealing; the Act raised the initial tax rate to 5%, effective for taxable years beginning after the date of enactment.. Participation in this case means that the foundation manager knows that the transaction is an act of self-dealing, his participation is willful and is not due to reasonable cause (such as exercising ordinary business prudence or relying on a written opinion of counsel). IRC § 4941(a)(2). If the foundation managers refuse to agree to all or part of the correction, an additional tax equal to 50% of the amount involved will be imposed. IRC § 4941(b)(2). Prior to the passage of the Pension Reform Act, section 4941 taxes on managers were capped at \$10,000 per transaction,

regardless of how many foundation managers participated; the Act raised the cap to \$20,000, effective for taxable years beginning after the date of enactment.. IRC § 4941(c)(2).

D. Sarbanes-Oxley and Related Proposals

In the summer of 2002, the law commonly known as the Sarbanes-Oxley Act was enacted in response to a rash of corporate accounting scandals and financial abuses. P.L. 107-204 (July 30, 2002). Only two provisions of the Sarbanes-Oxley Act apply to not-for-profit corporations:

- i) Whistleblower Protection. It is a criminal offense to punish whistleblowers who report to law enforcement officials truthful information about the possible commission of a federal offense. Sarbanes-Oxley Act § 1107.
- ii) Record Retention. It is a criminal offense (i) to, or to attempt to, alter, destroy, or conceal a document, record, or other object with the intent to impair its integrity or availability for use in an official proceeding, or otherwise to obstruct, influence or impede an official proceeding. Sarbanes-Oxley Act §§ 802(a), 1102.

Although only these two provisions of the Sarbanes-Oxley Act are imposed on not-for-profit corporations, it appears that an increasing number of nonprofits are voluntarily adopting policies similar to other Sarbanes-Oxley provisions. Perhaps this is a result, in part, of nonprofit directors' exposure to Sabanes-Oxley requirements through their service on for-profit boards.

In addition, there have been proposals at the federal and state levels to impose on nonprofits requirements similar to Sarbanes-Oxley provisions that currently apply only to for-profit corporations.

Legislation proposed in various forms by New York Attorney General Eliot Spitzer has been under consideration by the New York State Legislature for over 2 years. Other state legislatures have also considered legislation that would apply some of the concepts of Sarbanes-Oxley to nonprofit organizations, but the notion has been the subject of more debate than action. See Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. Davis L. Rev. 205 (2004); Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 Utah L. Rev. 1303 (2003). These developments will be discussed in “Developments in Governance Rules,” infra.

II. Practical Measures for Assuring Proper Board Behavior and Avoiding Liability

While the discharge of fiduciary responsibility is ultimately up to each individual, certain types of governance structure, particular patterns of conduct, and habits of deliberation will foster the careful and scrupulous performance of the board’s responsibilities. See, generally, Fishman, “Improving Charitable Accountability,” 62 Md. L. Rev. 218 (2003). These practical, concrete ways in which nonprofit organizations

can facilitate appropriate conduct by their officers and directors. are discussed in the balance of this outline.

A. Facilitating the Duty of Care

In concrete terms, the duty of care requires the director to be attentive to the affairs of the organization and to actively oversee the way in which its assets are managed. Particular structural mechanisms and procedures will aid organizations in carrying out their functions and reaching decisions in a careful and responsive manner.

1. To facilitate the directors' careful attention to corporate affairs, it is advisable to have structural features which maximize the likelihood that directors will have access to appropriate information and will carry out their responsibilities in the most efficient and conducive environment, including the following:
 - a. Formation of standing committees with responsibility for important functions, such as audit, compensation and budget, and personnel. This will allow for more focused attention on particular issues, allowing the full board to either delegate decision-making in this area to this smaller group or to rely on the committee's more considered recommendations.
 - b. Requiring regular meetings of the board, with a minimum number of meetings per year specified in the bylaws. This will increase the likelihood that directors will be exposed to a manageable amount of information and have time to make decisions in a responsible manner at each meeting.

- c. Requiring written agendas, minutes, and meaningful written materials to be distributed to the board in advance of the meetings. This will give the board sufficient notice of the matters to be discussed and allow time for necessary pre-meeting preparation by the board members.
 - d. Board size sufficiently large to allow diverse views and interests, but not so large as to be unwieldy. Specifying minimum and maximum number of directors in the bylaws is a good way of accomplishing this.
 - e. Board composition is a key structural factor toward assuring that responsibilities are discharged carefully. Boards should include people with substantive familiarity with the work of the organization, management and financial background, and people who can exercise judgment independent of the CEO and/or the controlling faction of the board.
 - f. Sufficient board turnover to guard against burn-out and excessive clubbiness, both of which tend to stifle lively debate and careful attention. Term limits should also be considered.
 - g. Limitation of the number of staff members that can serve on the board and/or delineation of the issues which must be discussed without board members from the staff in attendance. This is a partial brake on the common tendency toward staff control and domination of the board.
2. In addition, the duty of care requires that directors be in a position to exercise meaningful oversight, by behaving in certain ways, including:

- a. Becoming familiar with important corporate documents, such as the certificate of incorporation and by-laws.
- b. Regular monitoring of organization's finances, either directly or through the appropriate standing committees.
- c. Access to, and direct review of, corporate books and records.
- d. Regular attendance at board and committee meetings. Many practitioners recommend an attendance policy, which, of course, will be meaningful only to the extent it is taken seriously and enforced.
- e. Careful review of any written materials disseminated in advance of meetings or during the course of meetings.
- f. Delegation to qualified professionals of tasks requiring specialized expertise, especially if no one on the board has such expertise, and the regular opportunity to question such experts about issues facing the board. See N-PCL § 717(b) (allowing delegation to committees or experts and good faith reliance on information supplied by delegees).
- g. Insistence upon access to sufficient information, opportunity, and time to allow for informed and prudent decisions concerning issues facing the corporation.

B. Assuring the Duty of Loyalty

1. Common Trouble Spots. The duty of the board to give undivided loyalty to the not-for-profit is a key factor in advice as to the appropriate governance structure for a newly created organization or the proper procedures or policies by which the board of

an established organization should conduct business. The procedures and policies must be adequate to allow the not-for-profit to avoid common dual loyalty situations such as:

- a. Setting compensation for board members who are also employees of the organization or providing services to the organization. Compensation for the CEO who sits on the board is an especially tricky issue.
 - b. Contracts for goods or services between the organization and a firm owned or controlled by a board member, e.g., a bank, software vendor, or architectural firm.
 - c. Investment of organizational funds in companies or other investment vehicles where board members are also investors or otherwise have an interest in the investment.
 - d. Boards comprised of individuals in the same substantive field as the organization or affiliated with entities that seek funding from the same sources as the organization.
2. Procedures for Avoiding Conflicting Loyalties. In order to avoid situations where a board member's interest may improperly conflict (or appear to conflict) with the organization's interests, the not-for-profit should create an organizational structure where the best interests of the organization can be vigorously analyzed and pursued, through such mechanisms as:

- a. A board that is made up of individuals of diverse backgrounds and interests and is large enough so that no single faction controls. As discussed above, this will also facilitate the careful performance of the board's oversight.
 - b. Similarly, a board that turns over at regular intervals and has term limits will facilitate a fresh look at whether the organization's contracts and business arrangement serve the organization's best interests, as opposed to private interests of board members or staff, while helping the board perform its responsibilities carefully.
 - c. Lines of authority and committee structure within the board which encourage a sharing of power among people with diverse perspectives and economic interests will tend to safeguard against conflict situations.
3. Conflict of Interest Policies. The not-for-profit should also institute policies which address potential or actual conflicts of interest and set standards for permissible and impermissible conduct. These will generally include:
- a. A written statement articulating the criteria governing the board's consideration of transactions involving actual or potential conflicts of interest between the organization and the board member and reaffirming the board's duty of undivided loyalty to the not-for-profit.
 - b. A form to be completed by each board member annually, indicating that they are in compliance with the conflict of interest policy and stating any interest they may have in any transaction where consideration by the board is pending.

4. Conflict of Interest Procedures. The not-for-profit should be counseled to institute procedures for dealing with conflicts of interest which arise between board members and the organization. Since the “safe harbor” procedures outlined above are designed to avoid the conflicts of interest represented by excess benefit transactions, and, at the same time provide the organization with the benefit of the rebuttable presumption of reasonableness, these should be incorporated into the organization’s bylaws, including:

- a. Detailed written procedures to be followed when interested party transactions are proposed. The procedures should include disclosure of any director’s interest, some mechanism for independently assessing whether the proposed transaction is advantageous to the organization (such as studies of charges for similar transactions or competitive bids) and should address whether the interested director can be present during deliberations or voting, as well as whether the interested director can be counted for purposes of determining the existence of a quorum.
- b. Detailed written procedures to be followed when setting salaries or other compensation for any board members who are also employees or consultants. The procedures should require the compilation of comparative data concerning salary/compensation and should prohibit the board member from being counted in the quorum or being present during deliberations or voting.
- c. Procedures for detailed documentation of board approval of interested party transactions or other arrangements having even the appearance of conflicting

interests between the organization and a board member, including minutes reflecting disclosures by board members, consideration of comparative costs or market value information, and articulating any other factors considered by the board in approving the transaction.

III. Limiting Director and Officer Liability

Directors may come under scrutiny and be sued for breach of the fiduciary duties discussed above, for failing to cause the organization to comply with statutes of general applicability (such as civil rights laws, tax withholding requirements, and the prohibition of self-dealing and excess benefit transactions discussed above), or by third parties who have suffered financial or physical harm in their dealings with the organization.

Although federal and state “shield laws” provide some protection from lawsuits, and nonprofits may indemnify their officers and directors in many cases, obtaining insurance to cover directors’ and officers’ liability (“D&O insurance”) is often advisable.

A. Statutory Limitations

Under New York Law, a director or officer who serves a 501(c)(3) organization without compensation generally is not liable to third parties unless the conduct giving rise to the claim “constituted gross negligence or was intended to cause the resulting harm....” N-PCL § 720-a. Thus, directors and officers are protected from claims of ordinary negligence, unless they receive compensation (other than reimbursement for expenses) from the organization. There are several exceptions to this general rule, including actions brought by the New York Attorney General and claims of mismanagement of corporate assets. *Id.*

The federal Volunteer Protection Act of 1997, 42 U.S.C. § 14503(a), was enacted to encourage volunteer service to nonprofits and to limit the scope of liability faced by directors and officers, thus limiting the cost of D&O insurance. Like N-PCL § 720-a, the Act protects directors and officers from claims of ordinary negligence, though there are many exceptions. In addition, under certain circumstances the Act limits the damages for which a volunteer not otherwise protected by the Act may be liable.

B. Indemnification

Under New York law, indemnification for a given act may be mandatory, optional, or prohibited, depending on the nature of the act. A nonprofit *must* indemnify a director or officer who has successfully defended a civil or criminal action or proceeding, whether brought by a third party or “by or in the right of the corporation” (i.e., a “derivative” action). N-PCL §§ 723(a), 722(a), (c). In such cases, all costs must be reimbursed, including legal fees. Negotiated settlements of derivative actions do not give rise to mandatory indemnification; indemnification in such cases must be approved by a court. N-PCL § 722(c).

A nonprofit *may* indemnify a director or officer who acted in good faith and reasonably believed he was acting in the best interests of the corporation for the costs of defense and/or payment of a settlement or judgment in any civil or criminal case . N-PCL § 722(a), (c). However, such indemnification is only permitted with respect to a criminal action or proceeding only if the director or officer had no reason to believe that his conduct was unlawful.

A nonprofit may *not* indemnify a director or officer whose acts “were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled.” N-PCL § 721.

A nonprofit may pay the expenses of defending an action in advance of the final disposition of the action in exchange for an undertaking by or on behalf of the defending director or officer to repay such expenses. N-PCL §§ 723(c), 725(a). However, even if a director or officer is entitled to indemnification by the nonprofit she serves, the nonprofit may not be in a financial position to advance the costs of defending the action or proceeding, or even to reimburse the director or officer for such costs. Director and officer liability insurance can provide relief in these situations.

C. Director and Officer Liability Insurance

Director and officer liability insurance (“D&O insurance”) generally covers a director’s or officer’s costs, including legal fees, associated with a claim, the threat of a claim, or an investigation related to the director’s or officer’s nonprofit service, and provides reimbursement to the insured nonprofit for indemnity payments it makes to directors and officers. By ensuring payment of indemnified expenses, discussed immediately above, D&O insurance can reduce director’s or officer’s concerns about liability issues, thus helping the organization recruit and retain directors and officers. Further, D&O insurance provides coverage even where indemnification by the organization would be difficult due to public perception or political concerns. D&O insurance may also benefit the insured nonprofit by covering the *corporation’s* liability

for directors' and officers' acts that are attributable to the corporation. D&O insurance is expressly permitted by N-PCL § 726.

IV. Conclusion

In the current climate of increased public concern over not-for-profit “accountability” and increased regulation by the Internal Revenue Service in the excess benefit transaction arena, it is extremely important that practitioners advising not-for-profit boards provide concrete suggestions for implementing the fiduciary duties of care and loyalty and for providing indemnification and D&O insurance as hedges against disaster. As is so dramatically illustrated by the nonprofit scandals-du-jour appearing regularly in the press, volunteer boards ignore these obligations at their peril.