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SERVING ON THE BOARD OF DIRECTORS OF A NONPROFIT CORPORATION: LEGAL ISSUES

by Brad Caftel

RESPONSIBILITIES, DUTIES, RIGHTS, AND LIABILITIES

A. Status of Individual Directors

1. Each director is a fiduciary (trustee) of the corporation, and must act for the good of the corporation, not the director, with full honesty and reasonable care.
2. No special skill or experience is required, but each director must use the experience and ability each possesses, with unbiased judgment.
3. Removal provisions as permitted by state law are usually specified in the bylaws, and can be for cause or without cause. "Cause" can include breach of duty, missing a certain number of meetings, fraudulent or dishonest acts, or gross abuse of authority or discretion.

B. Rights of Individual Directors

1. Each director has the right to:
 - a. Receive notice of board meetings, agenda, minutes, and other informational materials.
 - b. Attend, participate, and vote in board meetings, and to challenge the convening of improper board meetings.
 - c. Examine personally or through an agent all corporate books and records: articles, bylaws, minutes, financial statements, contracts, etc.
 - d. Receive annual financial and other reports.

2. A director may receive reasonable compensation and reimbursement of expenses for services as a director, unless prohibited by state law or the bylaws. A director may also be a paid consultant or employee but should not participate in setting the compensation.

C. Taking Action

1. Directors must act as a group, not individually. A quorum (usually a majority of directors in office, or a majority of the authorized number of directors) of directors is needed to properly convene a meeting. Directors must be present in person or by conference telephone or similar communications equipment. Failure to attend board meetings may make a director liable for losses due to acts of mismanagement that the director's participation could have avoided.
2. If a quorum is present, the directors in attendance can act by majority vote, unless a greater percentage is required in the articles, bylaws, or state law. Directors cannot act by proxy, but can act by unanimous written consent without a meeting.
3. Minutes must be kept of all board and committee meetings in order to:
 - a. Record board policy and the reasons therefore. This assures that evidence of the board's actions and its reasons will be available in the event of litigation or investigation by regulatory or funding agencies.
 - b. Notify and direct officers and others who must carry out board policy.
 - c. Establish evidence of the scope and nature of the officers' authority.
 - d. Record the disapproval of any board action by a director, and the reasons for disapproval, even if absent when the action was taken. This may protect the individual director from personal liability for improper or illegal board actions.

D. Management Responsibilities

1. The board has general supervisory responsibility to:
 - a. Establish internal rules through bylaws and resolutions.
 - b. Establish policies: goals, objectives, priorities, timetables, procedures.
 - c. Authorize material transactions: investments, acquisitions, expenditures, etc.
 - d. Hire the executive director, monitor performance, remove if necessary.

- e. Select and remove other corporate officers.
 - f. Establish personnel policies.
 - g. Monitor corporate finances, both income and expenditures, often through an audit and finance committee.
 - h. Monitor and evaluate implementation of board policies and decisions.
2. The board has specific responsibility to ensure that:
- a. All corporate action is taken in compliance with the articles and bylaws.
 - b. All annual tax information returns and required reports are filed in a timely manner.
 - c. Members of the corporation receive financial and other reports.
 - d. All corporate action is consistent with the requirements for federal and state tax-exempt status. Section 501(c)(3) charitable and educational corporations must not:
 - i. Engage in more than an insubstantial amount of non-charitable or non-educational activity. A general rule is no more than 15% of the corporation's revenues and staff time can come from or be devoted to such unrelated activity.
 - ii. Participate in or intervene in any political campaign on behalf of or in opposition to any candidate for public office. The corporation must not use corporate facilities or corporate-paid-for time to engage in political activity.
 - iii. Engage in more than an insubstantial amount of lobbying (attempting to influence legislation).
 - iv. Permit net revenues to be used for the benefit of private individuals, for example, by paying excessive compensation to directors, officers, employees, or others.
 - v. Permit corporate assets and other resources to be used for other than charitable or educational purposes. The corporation may grant or loan its assets, but must take steps to ensure that their use is charitable or educational, by receiving and reviewing regular financial and programmatic reports. The corporation may lease space or provide staff support to others, as long as it is properly compensated.

- e. The requirements of state charitable solicitation statutes are met, including reporting requirements.
- f. If the corporation sells goods at retail or charges admission fees to entertainment events, sales and use taxes are collected, remitted, and reported.
- g. All property tax, business license fees, and other state and local taxes and fees are timely paid.
- h. The corporation has received an employer identification number, and has complied with federal and state withholding and payroll tax requirements, including the filing of forms and the collection and remittance of withheld funds. Individual director liability may result from failure to transmit withheld funds or willful failure to withhold taxes.
- i. The corporation has met its obligations under state unemployment and workers compensation laws.
- j. All conditions imposed by grant funding sources are met.
- k. All corporate funds and assets not expended directly in its activities are invested to yield a reasonable return without undue risk.
- l. All corporate property and assets are adequately protected by insurance or otherwise.

E. Delegating Management Responsibilities

- 1. Directors may delegate day-to-day management functions and authority to committees, officers, and others, as long as the board retains ultimate control and direction. Directors must use due care in delegating authority and must check periodically on those performing delegated functions, e.g. review committee reports and minutes of meetings. Directors cannot escape liability by avoiding or delegating duty.
- 2. Directors may rely on information prepared or presented by corporate officers and employees, legal counsel, independent accountants, other professionals or experts, and board committees, on matters within their authority. This reliance must be in good faith, in the belief that the presenter is reliable, competent, or expert in the matter, after reasonable inquiry, and without knowledge that would cause reliance to be unwarranted. Directors are not excused from making some independent inquiry of the activities and status of the corporation.

F. Duty of Care in Exercising Management Responsibilities

1. Each director must exercise the degree of care that an ordinarily prudent person in a like position would use under similar circumstances. Good faith is not enough. Thus, directors, will not be held personally liable for the debts, liabilities or obligations of the corporation when they exercise ordinary and reasonable care in the performance of their duties, acting honestly and in good faith in the best interests of the corporation. Personal liability of directors is rare; the burden is on others to show that this standard of care was not met.
2. A director will generally not be liable for honest mistakes in business judgment, but may be liable for one's own gross negligence, fraud, or intentional misconduct detrimental to the corporation or others, or for otherwise failing to exercise reasonable care and diligence.

G. Duty of Loyalty to the Corporation

1. Each director must subordinate personal interests to the welfare of the corporation, whenever the two are in conflict.
2. Directors must refrain from engaging in personal activities that would injure or take advantage of the corporation. Directors may not, directly or indirectly, make secret profits out of their official position. For example, directors may not use confidential information of the corporation, such as trade secrets, for personal gain.
3. If a director has a personal interest, direct or indirect, in a proposed contract or transaction, such interest should be fully disclosed to the board, and carefully examined by the other directors. The provisions of state law governing "self dealing (conflict of interest)" transactions must be followed, as must any relevant grant restrictions.
 - a. All material facts regarding the proposed transaction must be disclosed to the board.
 - b. The board must ratify the transaction without counting the vote of the interested director. The disinterested directors should ask:
 - i. Is the transaction made in good faith?
 - ii. Are the price and terms fair and reasonable and in the best interests of the corporation, or can the corporation get a better deal elsewhere?
 - iii. Did the interested director conceal any material fact from the directors?

- c. Such transactions are usually voidable, not automatically void.
 - d. A director may be compensated for services rendered to the corporation in a capacity other than that of director, e.g., attorney or real estate broker, as long as the above procedures are followed.
 - e. Remedies for violating these rules include repayment to the corporation of profits from the transaction, repayment to the corporation for the use of its property in the transaction, and return of property to the corporation together with any lost income or appreciation.
4. With limited exception, loans to directors and officers are prohibited. A director who votes for or abstains from voting on a prohibited loan is liable for its repayment. The corporation may advance money to a director or officer for reasonably anticipated expenses to be incurred in the performance of their duties, provided that the director or officer would otherwise have been entitled to reimbursement for such expenses.
5. A director must not compete with the corporation.
- a. A director may have interests in other businesses, but must not use the position as director to prevent the corporation from competing with the director's other businesses.
 - b. A director must not use the corporation's property or know-how for the benefit of the director's other businesses.
 - c. A director must not accept payment for urging the corporation into a particular transaction.
 - d. A director may not use confidential information (trade secrets, mailing lists, etc.) acquired as a director at any time, even after leaving the board.
6. A director must not divert corporate opportunities for personal gain.
- a. A director must not seize an opportunity presented to the corporation, within the scope of its activities, and from which the corporation could benefit.
 - b. A director may proceed with an opportunity that is not within the corporation's activities, or that the corporation could not accept or has rejected, if the director acts in good faith.

7. Transactions between nonprofit corporations with interlocking boards are generally valid if fair and reasonable, even when there is no disinterested majority.
8. A director may receive a benefit from the corporation offered on the same basis to non-directors. For example, if any low-income person in a certain area is eligible to use a corporation's facility, a low-income director in that area may use the facility.

INDEMNIFICATION, INSURANCE, AND OTHER PROTECTIVE METHODS

A. Indemnification

1. Indemnification involves shifting the cost to the corporation of an individual director's expense incurred in defense or settlement of an action or proceeding against the director.
2. Indemnification is mandatory if the director is successful on the merits, is discretionary otherwise, and is prohibited if the director is found to have breached a duty to the corporation. Bylaw provisions may either permit or require the corporation to indemnify directors to the maximum extent permitted by state law. To be indemnified, the director must have acted in good faith and in a manner the director reasonably believed to be in the best interests of the corporation.
3. The corporation may advance expenses incurred by the director in defending any proceeding, if the director undertakes to repay the advance unless it is ultimately determined that the director is entitled to be indemnified.

B. Insurance

1. The corporation may purchase directors' and officers' liability insurance. The insurance can cover any liability, whether or not the corporation would have the power to indemnify against such liability, except for self-dealing (conflict of interest) transactions.
2. Contact an insurance broker to investigate insurance availability and price. Insurance can be expensive and sometimes difficult to obtain. It is often not a good buy for well-run corporations. Usually, its only real benefit is to pay the cost of legal defense.
3. Check the insurance policy for exclusions. Typically, fraudulent acts are excluded. Exclusions for such matters as personnel claims may limit the usefulness of the policy. Policies are typically "claims made", that is, matters that occur during a policy period are not covered unless the claim is also made during a policy period.

C. Other Protective Methods

1. Form a separate corporation with its own board of directors to engage in certain activities.
2. Insert an indemnification, hold harmless, and/or waiver of liability clause in consultant and employment contracts, and in other contracts and agreements. This may not protect against injuries to third parties.
3. Reimburse directors and officers for the purchase of a personal umbrella liability insurance policy as a rider to their homeowners and auto insurance.
4. Avoid the most common cause of individual director litigation, employer-employee grievances, by establishing and following written personnel policies and procedures. Limit the board's role in personnel matters to supervision of the executive director.