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Avoiding Liability as a Nonprofit Director

Nonprofit does not mean non-risk. Donating time to serve on the board of directors of a nonprofit organization, one should understand the required duties. Failing to discharge those duties can subject a director to lawsuits by individuals, ranging from disgruntled employees to concerned beneficiaries, as well as government investigations and even criminal indictments. Consider these real examples:

- Your nonprofit's president is accused of misusing funds to take extravagant trips and reward friends and family members with jobs. Investigators ask why you and your fellow board members gave the president unchecked authority over the company's incorporated spin-offs and why your board lacks a compensation committee, which could have found and dealt with the improper conduct before a governmental investigation was necessary. *See* Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. Corp. L. 631, 633-644 (1998) ("Goldschmid").
- You serve as a trustee for a nonprofit college, whose president is the second highest paid college head in the nation. As a result of declining student enrollment, the president becomes highly unpopular among all segments of the college, except among the trustees, all of whom he appointed. An investigation reveals massive expenditures to pay for the president's benefits, including an $85,000 automobile, a rent-free apartment, and an allowance of $150 per glass for cognac, none of which were approved by the trustees, as well as various self-dealings by trustees. The state's board of regents is now considering whether to remove you and your fellow trustees. *Id. See also* Cherry, *Update: The Current State of Nonprofit Director Liability*, 37 Duq. L. Rev. 557, 566 (1999) ("Cherry").

In serving as a nonprofit director there is no certain rubric that will shield you or the nonprofit organization from potential liability. A director who is aware of the legal responsibilities, however, is more likely to make decisions that will ultimately permit the organization to advance its goals without the distraction of accusations of wrongdoing.

This article discusses those responsibilities and alerts potential directors to some considerations they should make when deciding whether to become directors.

What Are the Duties of a Nonprofit Director?

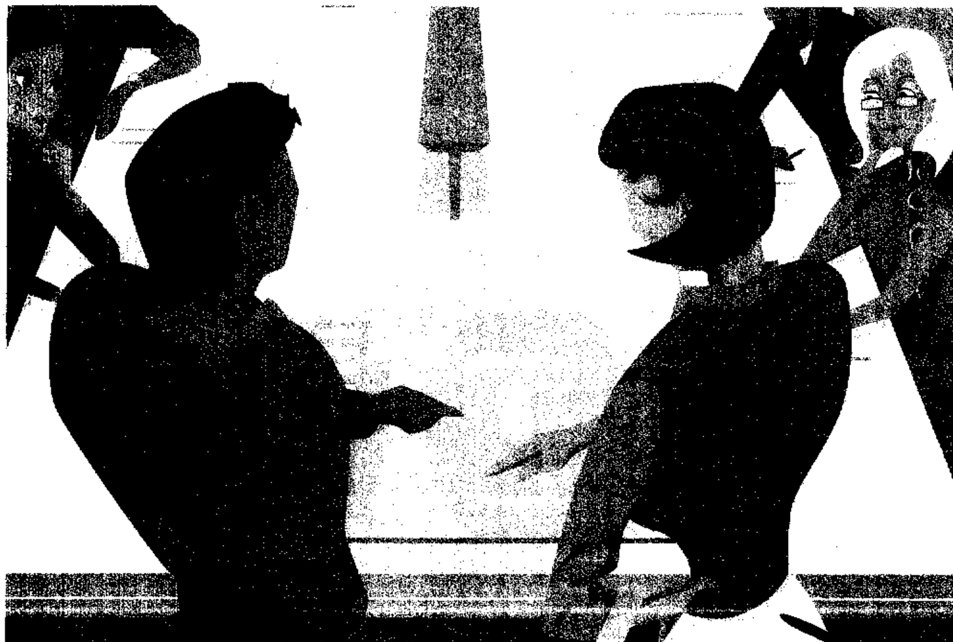
Generally, a nonprofit is an incorporated organization which distributes no part of its income to its members, directors, or officers. In return for its public services, certain advantages are afforded the nonprofit, including exemption from taxes on revenues, provided that any profit earned from its activities must remain within the corporation for program improvement, enhancement, or expansion. A nonprofit director needs to discharge three basic duties: (1) care, (2) obedience, and (3) loyalty.

The Duty of Care

The duty of care or diligence requires directors to take their responsibilities seriously by keeping informed about and active in the organization. A director must "discharge [his or her] duties in good faith, with the care that an ordinarily prudent person in a like position would reasonably believe appropriate under similar circumstances." ABA Committee on Nonprofit Corporations, *Guidebook for Directors of Nonprofit Corporations*, 2d ed., 2002, at 19 ("ABA Guidebook"). The duty of care generally requires a director to:

1. attend and participate in board and committee meetings;
2. stay informed of the organization's purposes, goals, and activities, as well as its budget and finances;
3. exercise independent judgment; and
4. obtain and use adequate information before voting and acting.

A director does not need to "'exhaustively research every issue'" to meet the duty of care. Cherry, 37 Duq. L. Rev. at 560. Nor will a director be subject to liability for honest, reasoned mistakes of judgment. Instead, the duty of care is intended to protect nonprofits from more serious or chronic wrongdoing, such as the director who never attends meetings or who refuses to review even important financial and organizational materials. Failure to attend meetings can be a breach of duty, and a director's absence from board meetings will not shield that person from any liability arising from the board's actions which active participation might have prevented. If a person cannot attend meetings on a regular basis, declining to serve or resignation is appropriate. The best practice for a director is to treat the nonprofit with the same consideration and care given to the director's own interests.



The Duty of Obedience

The duty of obedience prohibits directors from engaging in transactions or activities that are outside the scope of "the corporation's powers and purposes as expressed in its certificate of incorporation," Fishman, *Improving Charitable Accountability*, 62 Md. L. Rev. 218, 237 (2003), requiring a director to act in furtherance of the organization's stated goals and not act in a way inconsistent with its charter or by-laws.

The Duty of Loyalty

Corporate officers and directors must show "undivided and unselfish loyalty to the corporation." *IOS Capital, Inc. v. Phoenix Printing, Inc.*, 808 N.E.2d 606 (Ill. App. Ct. 4th Dist. 2004). A director cannot "use a corporate position for individual personal advantage." ABA Guidebook at 29. The director may not usurp an opportunity of interest to the organization without first giving the nonprofit the opportunity to decline it. A director must keep the organization's confidences; that is, the director may not disclose information about the corporation's activities unless they are either publicly known or a matter of public record.

What Is a Conflict of Interest?

The specter of conflicts appears when a director has a material personal interest in any proposed action the organization may take or in any transaction to which the organization may be a party. ABA Guidebook at 30. A conflict of interest can be *direct*, when the director is personally involved in the transaction, such as where it is proposed that the nonprofit hire the director's law firm or where the nonprofit purchases property from the director. Or a conflict of interest may be *indirect*, when the director has a relationship with a party who is involved with the transaction, such as where a relative owns an entity that is proposed for hire. A conflict can even occur when a director receives no money in connection with the transaction. One common conflict arises when the organization's executive, who may sit on the board as a director, also acts or votes to set his or her own compensation. An organization is well advised to separate such people from those decisions.

While some argue that directors should disengage from *any* self-dealing, this may not always be possible or beneficial. For example, certain "interested" transactions such as a director performing professional services for the nonprofit (*e.g.*, as attorney) can eliminate certain costs for the organization. Additionally, a director may be able to provide a better quality of service for the nonprofit, because of particular knowledge of the organization and its workings. Goldschmid, 23 J. Corp. L. at 648. The prudent director should be ever alert to the possibilities of conflicts in approving such arrangements and make sure that transactions in which conflicts are present be given the heightened scrutiny they deserve.

Dealing with Conflicts of Interest

State laws typically require *full disclosure* of the existence of conflict by the involved director, who should disclose details of the connection giving rise to the conflict (*e.g.*, family relationship, business relationship, or financial interest) *before* any action is taken by the organization. ABA Guidebook at 30, 33.

A nonprofit should have a conflicts of interest policy that defines what constitutes a "financial interest," a "personal interest," and "compensation;" explains a director's disclosure duty; and establishes voting procedure where a conflict exists. For example, such a policy may allow an interested director to participate in a discussion of the transaction but require abstention from voting. By establishing a conflicts of interest policy in advance, directors will be more aware of what constitutes a conflict and understand their responsibilities in this regard.

In Illinois, like most states, a director will not breach a duty of loyalty and the transaction will not be voided as long as the corporation can show that:

1. the transaction was approved by a disinterested majority of the board or a designated board committee after full disclosure by the affected director of the material facts regarding the transaction and the director's interest therein; and/or
2. the transaction was fair to the corporation at the time it was entered into.

Id. at 31; *see also* 805 ILCS 105/108.60.

State Registration Issues

A nonprofit usually must be registered in the state where it is incorporated. While the

organization's executive director or president usually is charged with the responsibility of making and maintaining filings, such as the state registration, the prudent director should make sure that the board provides oversight of this function. If the nonprofit is affiliated with a national organization, the board should be sure that the national affiliation is being maintained by paying dues or complying with any other requirements that that organization might have. Loss of national affiliation can have serious consequences, such as the loss of 501(c)(3) status or use of the national organization's trademarks in fundraising. Having the executive director circulate copies of the pertinent filings among the board and perhaps making them a board agenda item can safeguard the organization.

Payroll Tax Responsibilities

Federal law requires that employers deduct and withhold social security and income taxes from their employees. Under federal law, a director may be held *personally liable* as a "responsible person" for an organization's failure to collect, account for, *or* pay taxes overdue under provisions of the Tax Code. 26 U.S.C.A. § 6672(a), construed in *Slodov v. United States*, 436 U.S. 238 (1978). Courts generally have held that an officer or director is a "responsible person" when he or she has "significant control over the disbursal of corporate funds." *Purdy v. United States*, 814 F.2d 1183, 1188 (7th Cir. 1987) (citation omitted). The greater direct decision-making authority a director has over payments from the corporate coffers, the more likely the director will be found to be a "responsible person." Thus, a director who signs off on checks or tax payments, or sits on the board's finance committee, is more likely to be considered a "responsible person" than a director who lacks these responsibilities.

Finally, courts in Illinois and elsewhere have found "responsible persons" to have been "willful" in their failure to comply with tax provisions, thus subjecting them to liability, where they knew or clearly ought to have known that "there was a grave risk that withholding taxes were not being paid and [they] [were] in a position to find out very easily [whether such taxes were being paid]." *Wright v. United States*, 809 F.2d 425, 427 (7th Cir. 1987). Therefore, a director who has authority over corporate disbursements should meet regularly with the corporation's finance personnel or auditors and fully investigate any irregularities.

Tax Exempt Status Issues

To qualify as a tax-exempt organization under Section 501(c)(3) status, an organization must submit financial statements to the IRS. Additionally, many state laws require audited financials for nonprofit above a certain size. In Illinois, audited financials are required if gross receipts exceed $150,000 or if a professional fundraiser raises over $25,000 for the nonprofit. 225 ILCS 460/4(a). If statements must be audited, an organization and, either directly or indirectly, its directors, are often asked to certify the following matters:

1. that financial statements conform with Generally Accepted Accounting Principles ("GAAP");
2. that the nonprofit provided the auditors with all financial records and board meeting minutes and has properly recorded all material transactions;
3. whether there have been any communications with regulatory agencies regarding compliance issues; and

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4. whether there has been any fraud by management, employees, or others.

AICPA Professional Standards, AU § 333 (Draft, Feb. 6, 2003).

If directors are not satisfied that these types of representations can be made, they should seek assurances that the representations are accurate or identify corrective action that may be needed.

Nonprofits must keep their status as a 501(c)(3) organization by maintaining adequate records to track donations and grants, noting any benefit conferred on donors, and ensuring state or local taxes (such as payroll taxes, real estate taxes, or sales taxes on goods or services sold) have been paid or are exempt from payment.

There are other requirements that a nonprofit must meet for its 501(c)(3) status, such as avoiding political contributions. The numerous requirements of Section 501(c)(3) are good reason for every nonprofit organization to work with an accountant and/or attorney with experience in advising nonprofits on these issues.

Limits on Director Liability— The Business Judgment Rule

The business judgment rule provides protection for nonprofit directors from liability, as long as they "acted in good faith and in a manner reasonably believed to be in the corporation's best interest, and with independent and informed judgment." ABA Guidebook at 28. While courts applying the rule acknowledge that it is inappropriate to second-guess corpora: management decisions, courts will not give directors protection under the rule where allegations of "criminal activity, fraud, bad faith, [or] willful and wanton misconduct" are present.

When applicable, the standard for liability under the rule is "gross negligence" rather than "ordinary negligence." Gross negligence is considered to be " 'reckless indifference or a deliberate disregard of the stockholders or…actions which are without the bounds of reason'." Lee, *The Business Judgment Rule: Should It Protect Nonprofit Directors?*, 103 Colum. L. Rev. 925 (2003) ("Lee"), quoting *Rabkin v. Philip A. Hunt Chem. Corp.*, 547 A.2d 963, 968 (Del. Ch. 1986) (citations omitted).

Illinois-Specific Nonprofit Laws

State laws may limit nonprofit director liability under certain circumstances but add additional duties in other instances. While it is not possible to discuss all applicable law in the context of this article, we highlight a few provisions warranting attention.

Most states limit director liability through "volunteer protection laws." Illinois immunizes directors serving at a personal compensation of less than $5,000 per year from personal liability, except for "willful or wanton misconduct." 805 ILCS 105/108.70(b) defines such misconduct as "a course of action which shows an actual or deliberate intention to cause harm or which, if not intentional, shows an utter indifference to or conscious disregard for the safety of others or their property." 805 ILCS 105/108.70(d). The Uniform Management of Institutional Funds Act (in effect in 46 states, including Illinois) establishes a standard of care that follows the business judgment rule, directing that members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. *Id.* at § 12.01[3] at 12-7.

Finally, Illinois is not among the small minority of states that hold all nonprofit directors to the higher duty of care associated with trusts. In California, for example, courts have found that the assets of a charitable corporation are impressed with a trust; thus, a director can breach the duty of

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care for mere negligence, rather than gross negligence. Lee, 103 Colum. L. Rev. at 936. In Illinois, only actual trustees are held to this higher standard. However, Illinois uses the rather broad definition of "trustee" as follows:

> [A]ny person, individual, group of individuals, association, corporation, not-for-profit corporation, estate representative, or other legal entity holding property for or solicited for any charitable purpose; or any chief operating officer, director, executive director or owner of a corporation soliciting or holding property for a charitable purpose.

760 ILCS 55/3.

As arguably any director of a nonprofit that solicits or holds property "for a charitable purpose" could be considered a "trustee," prudent directors should consult with an attorney to determine whether they may be deemed a "trustee" and thus held to a higher standard of care.

Indemnification and Insurance

Corporate indemnification of and insurance for loss associated with service to a nonprofit may be available from either a nonprofit or a for-profit employer if either asks someone to serve on a nonprofit board. In deciding whether to serve as a nonprofit director or officer, you should review a corporation's by-laws and articles of incorporation and make inquiries about the availability and extent of indemnification and insurance.

Risks Are Inherent, But Liability Can Be Avoided

Directors who observe the duties of care, obedience, and loyalty positively contribute to the nonprofit itself, while reducing their risk of legal liability. The educated director who confirms that corporate formalities are observed on such matters as maintaining 501(c)(3) status, state registration, and national affiliation will help the organization avoid common mistakes that can lead to liability. Putting a conflicts of interest policy in place and paying attention to situations in which conflicts arise should protect the organization and, thus, the director, from those who might seek to profit at the organization's expense.

This is not to say that a nonprofit director will always avoid liability. As with any endeavor worth doing, risks are involved in the business of the nonprofit. Treating the nonprofit's business with the same care directors give to their own, however, should steer both the director and the organization away from trouble, while facilitating the organization's good work. ■

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