

LEGAL ISSUES FOR NONPROFIT ORGANIZATIONS AND THEIR BOARDS

September 22, 2011 • Cashmere, Washington

Presented by *Mary R. Giannini*

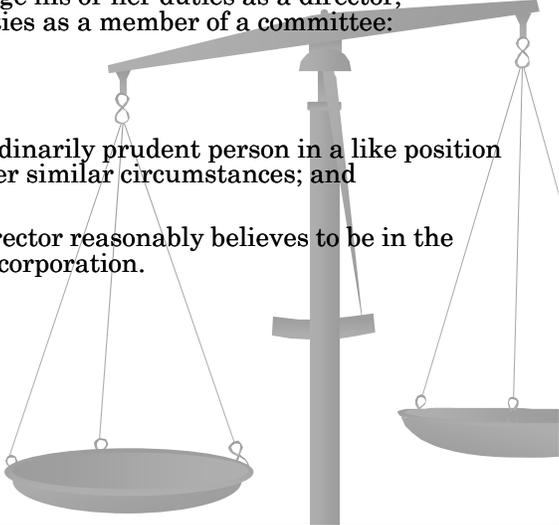
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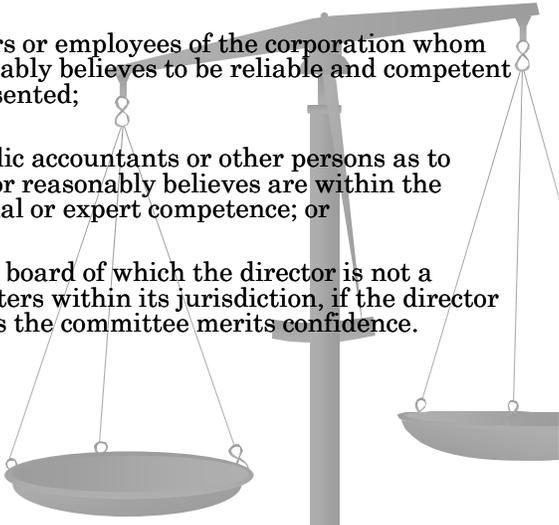
MINIMIZING AND AVOIDING THE IMPOSITION OF LIABILITY

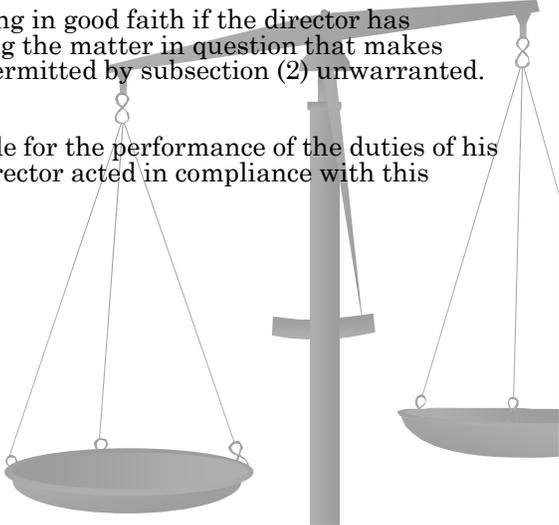
A. Responsible Governance Practices.

A key way board members can protect themselves from liability is by following good governance practices.

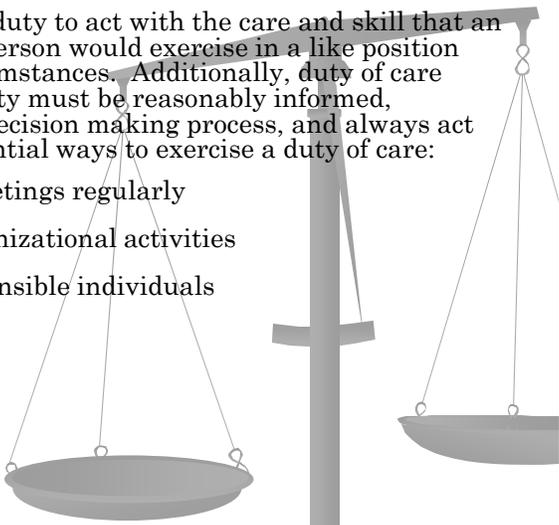
A good example of the standards for a director can be found in Section 8.30 of the Revised Model Nonprofit Corporation Act of 1986 ("RMNCA"). It provides as follows:

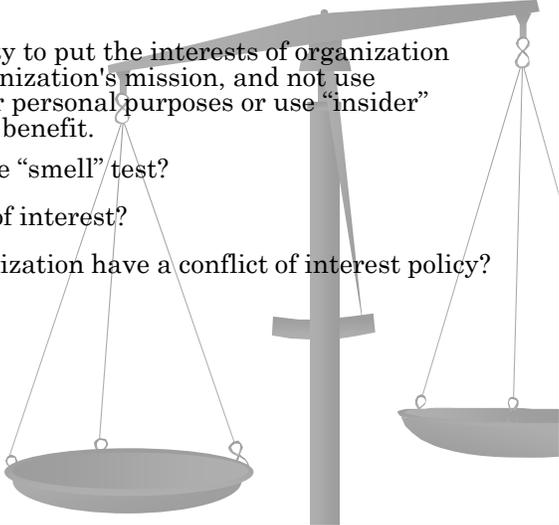
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1. A director shall discharge his or her duties as a director, including his or her duties as a member of a committee:
 - a. In good faith;
 - b. With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
 - c. In a manner the director reasonably believes to be in the best interest of the corporation.

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2. In discharging his or her duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
 - a. One or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
 - b. Legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
 - c. A committee of the board of which the director is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence.

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3. A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (2) unwarranted.
 4. A director is not liable for the performance of the duties of his or her office if the director acted in compliance with this section.

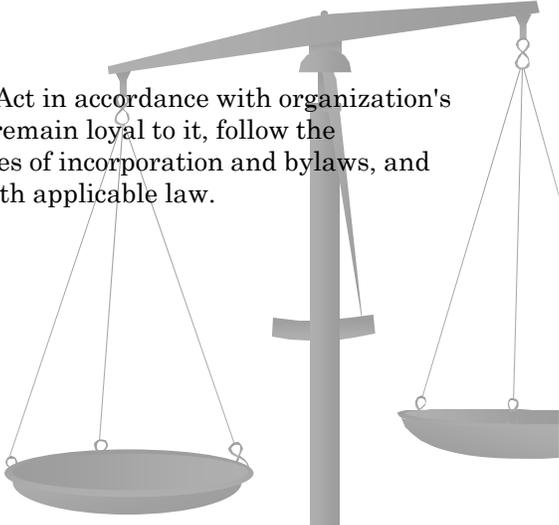
B. Three Basic Duties.

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1. *Duty of Care*. The duty to act with the care and skill that an ordinary prudent person would exercise in a like position under similar circumstances. Additionally, duty of care means that the party must be reasonably informed, participate in the decision making process, and always act in good faith. Potential ways to exercise a duty of care:
 - Attend board meetings regularly
 - Know about organizational activities
 - Delegate to responsible individuals
 - Follow up



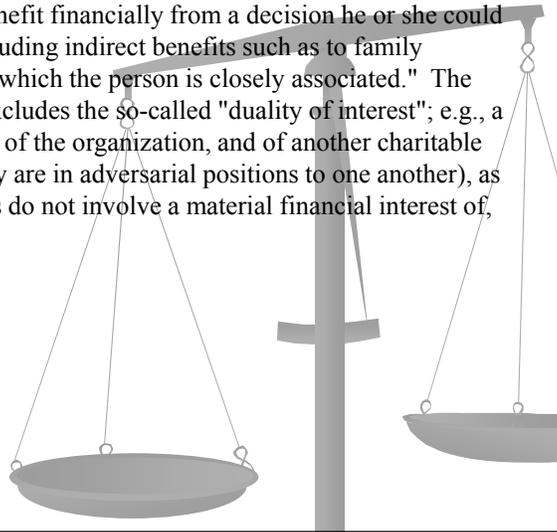
2. *Duty of Loyalty*. The duty to put the interests of organization first -- dedication to organization's mission, and not use organization property for personal purposes or use "insider" information for personal benefit.

- Does it pass the "smell" test?
- Is it a conflict of interest?
- Does the organization have a conflict of interest policy?



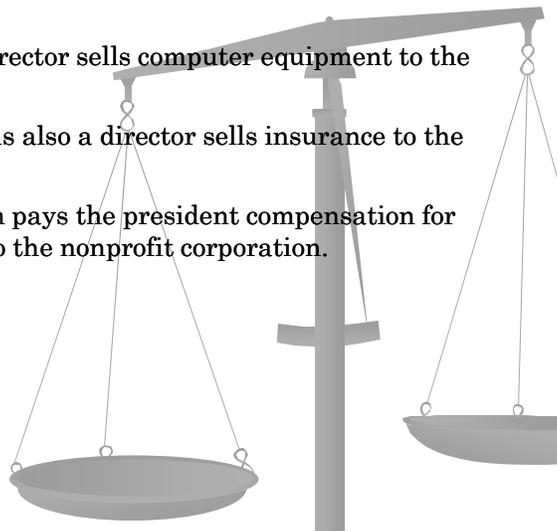
3. *Duty of Obedience*. Act in accordance with organization's stated mission and remain loyal to it, follow the organization's articles of incorporation and bylaws, and act in accordance with applicable law.

4. *Conflict of Interest*. The IRS defines "Conflicts of Interest" as arising when "a person in a position of authority over an organization (e.g. an officer, director or manager) may benefit financially from a decision he or she could make in such a capacity, including indirect benefits such as to family members or businesses with which the person is closely associated." The IRS definition of conflicts excludes the so-called "duality of interest"; e.g., a person serving on the boards of the organization, and of another charitable organization (even when they are in adversarial positions to one another), as long as such dual board roles do not involve a material financial interest of, or benefit to, the person.



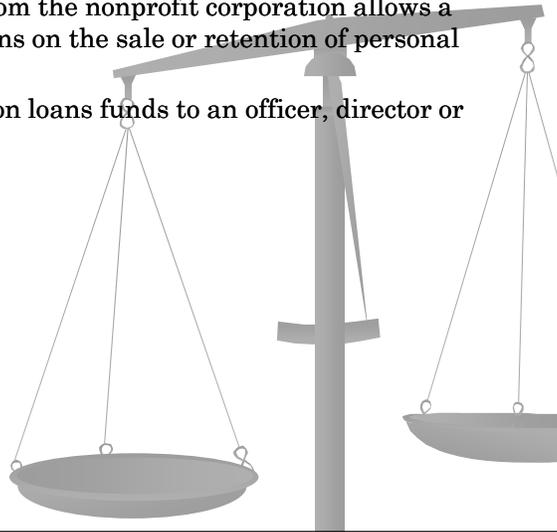
Examples of Conflicts of Interest

- A business owned by a director sells computer equipment to the nonprofit corporation.
- An insurance agent who is also a director sells insurance to the nonprofit corporation.
- The nonprofit corporation pays the president compensation for the president's services to the nonprofit corporation.



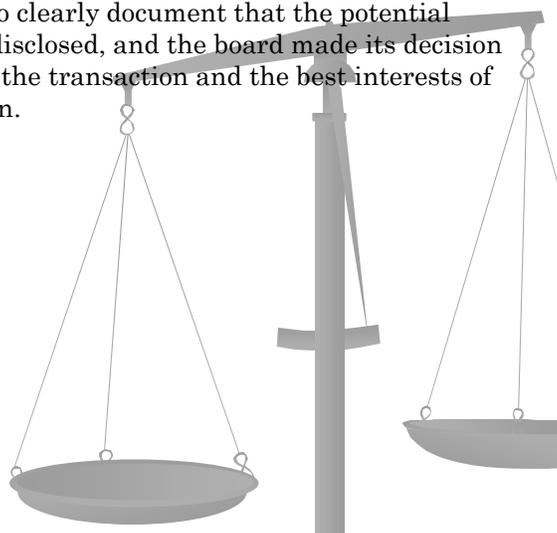
Examples (cont.)

- Information obtained from the nonprofit corporation allows a director to make decisions on the sale or retention of personal assets.
- The nonprofit corporation loans funds to an officer, director or other key player.



How should a Conflict of Interest be addressed?

- Overall goal should be to clearly document that the potential conflict of interest was disclosed, and the board made its decision based on the fairness of the transaction and the best interests of the nonprofit corporation.



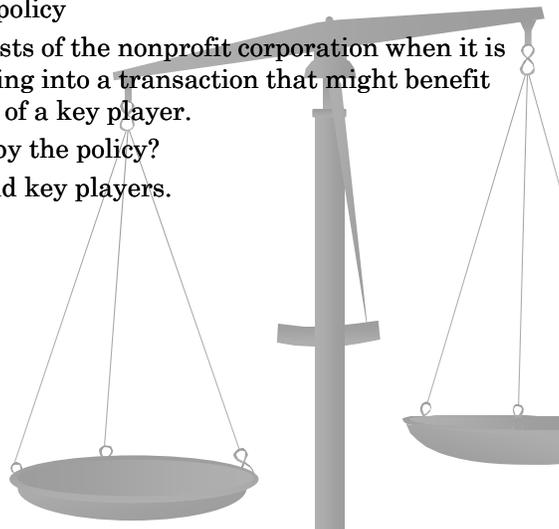
How should a Conflicts of Interest be addressed? (cont.)

- Preemptive steps:
 - Adopt a conflict of interest policy.
 - Review the policy annually with relevant parties.
 - Require periodic certification from relevant parties indicating they have read and understood the policy and that they have and will comply with the policy.



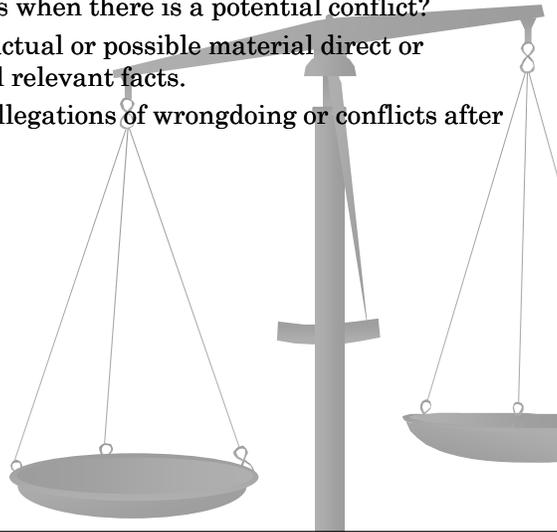
Anatomy of a Conflict of Interest Policy

- Overall objective of the policy
 - To protect the interests of the nonprofit corporation when it is contemplating entering into a transaction that might benefit the private interests of a key player.
- Who should be covered by the policy?
 - Directors, officers and key players.



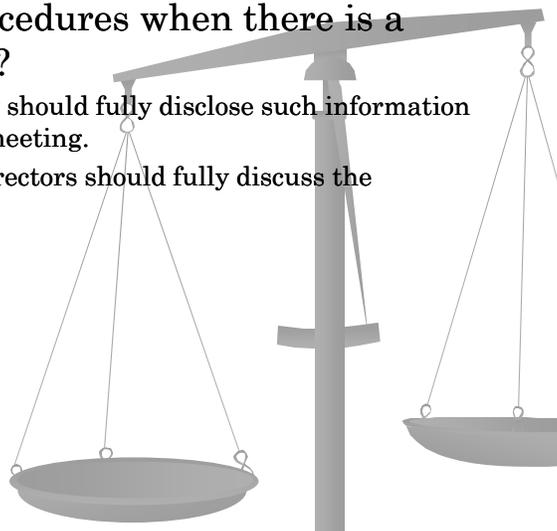
Anatomy of a Conflict of Interest Policy (cont.)

- What are the procedures when there is a potential conflict?
 - Duty to disclose all actual or possible material direct or indirect conflicts and relevant facts.
 - Duty to respond to allegations of wrongdoing or conflicts after the fact.



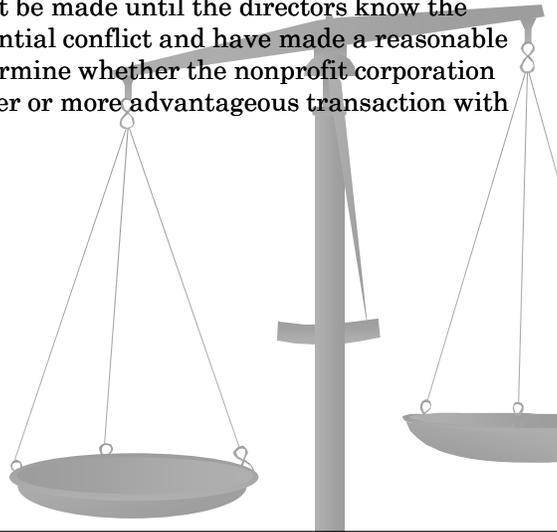
Anatomy of a Conflict of Interest Policy (cont.)

- What are the procedures when there is a potential conflict?
 - The interested party should fully disclose such information and then leave the meeting.
 - The disinterested directors should fully discuss the information.



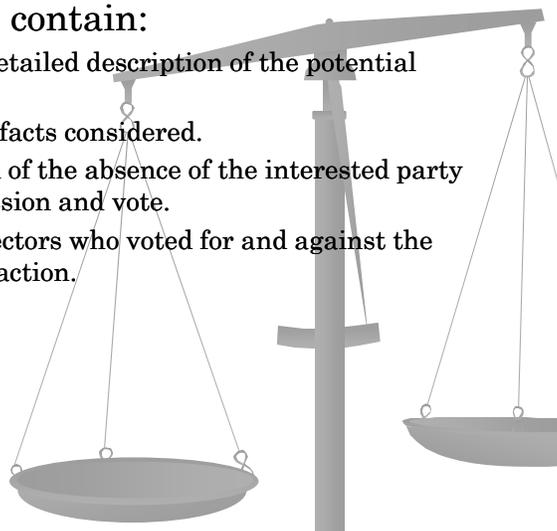
Anatomy of a Conflict of Interest Policy (cont.)

- A decision should not be made until the directors know the full scope of the potential conflict and have made a reasonable investigation to determine whether the nonprofit corporation can enter into a better or more advantageous transaction with a different party.



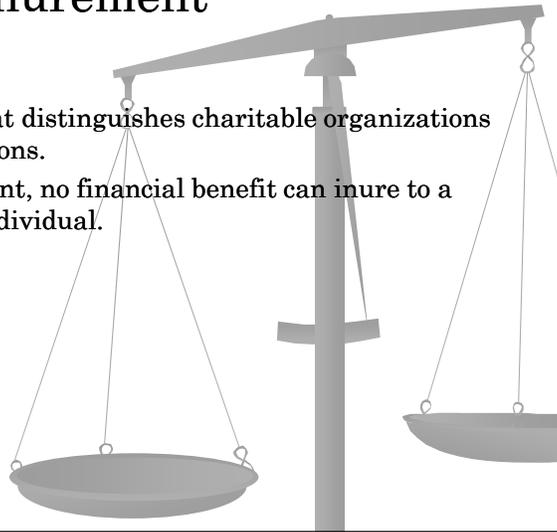
Anatomy of a Conflict of Interest Policy (cont.)

- Minutes should contain:
 - A reasonably detailed description of the potential conflict.
 - The additional facts considered.
 - Documentation of the absence of the interested party from the discussion and vote.
 - A list of all directors who voted for and against the proposed transaction.



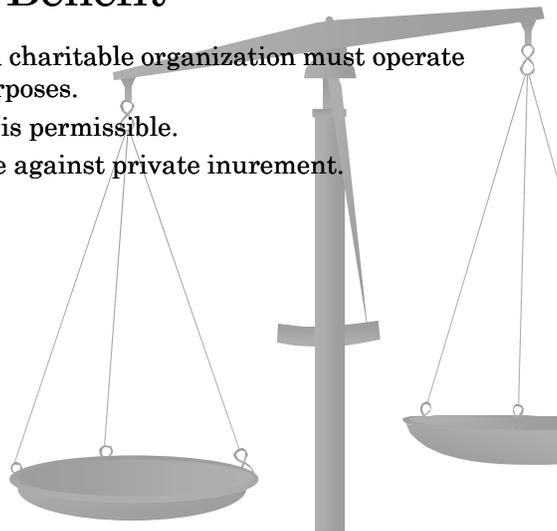
Minimize Risks Through Understanding the Law – Private Inurement

- Fundamental concept that distinguishes charitable organizations from for-profit organizations.
- To avoid private inurement, no financial benefit can inure to a shareholder or private individual.



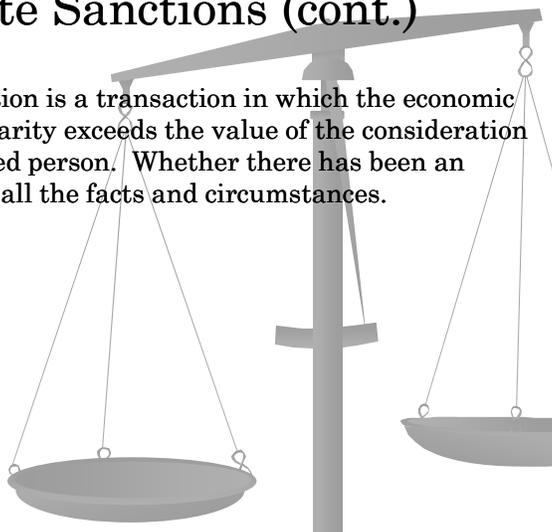
Minimize Risks Through Understanding the Law – Private Benefit

- To avoid private benefit, a charitable organization must operate exclusively for exempt purposes.
- Incidental private benefit is permissible.
- Broader rule than the rule against private inurement.



Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- An excess benefit transaction is a transaction in which the economic benefit provided by the charity exceeds the value of the consideration provided by the disqualified person. Whether there has been an excess benefit depends on all the facts and circumstances.



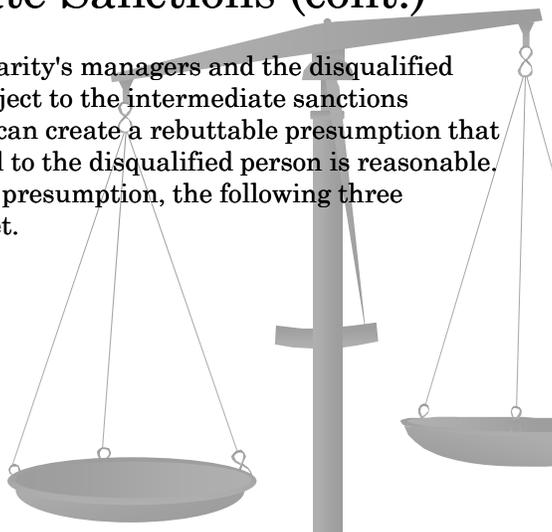
Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- Reasonable compensation is not an excess benefit and therefore does not trigger the intermediate sanctions penalties.
- An economic benefit received by a disqualified person is considered compensatory only if the public charity clearly indicates its intent to treat the benefit as compensatory.



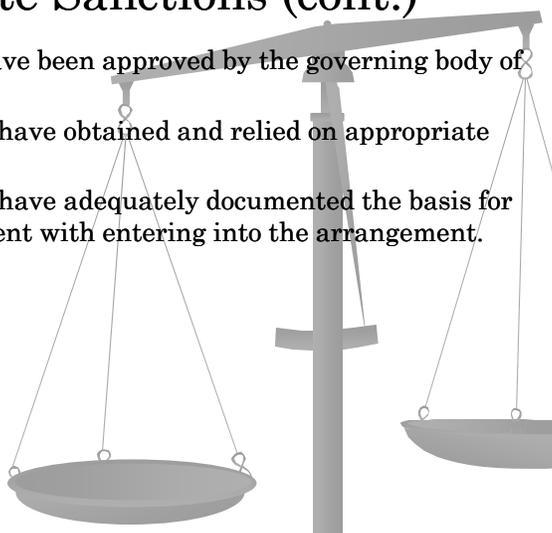
Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- To protect both the charity's managers and the disqualified person from being subject to the intermediate sanctions penalties, the charity can create a rebuttable presumption that the compensation paid to the disqualified person is reasonable. In order to create this presumption, the following three conditions must be met.

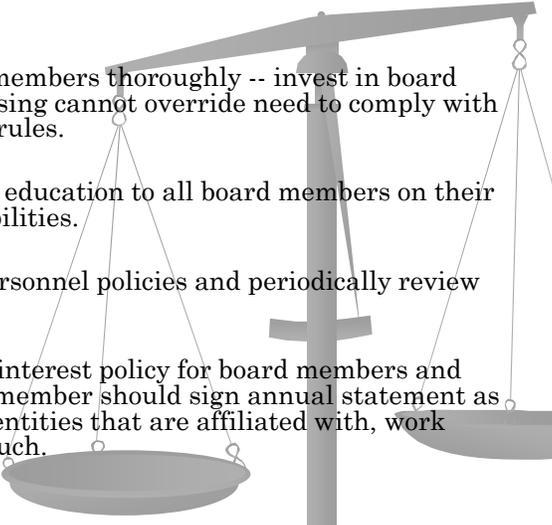


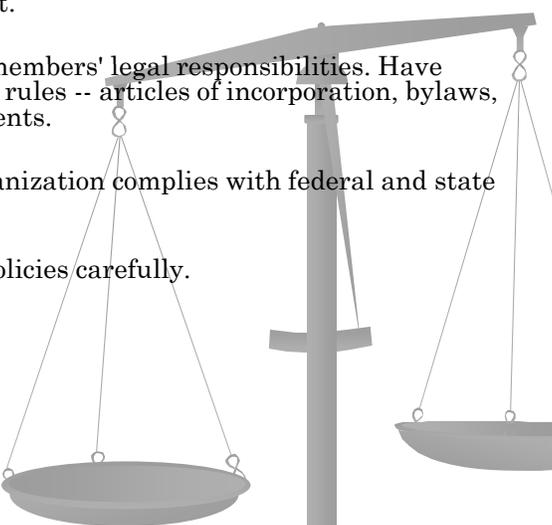
Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- The arrangement must have been approved by the governing body of the charity.
- The governing body must have obtained and relied on appropriate comparable information.
- The governing body must have adequately documented the basis for its determination concurrent with entering into the arrangement.



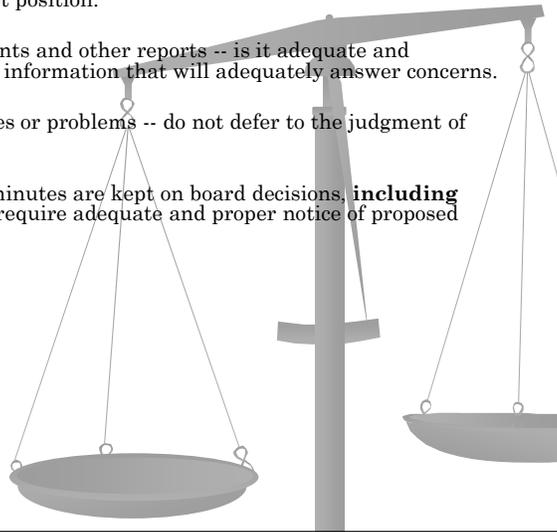
C. Practical Examples of Good Governance Standards

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1. Organizational.
 - a. Orient new board members thoroughly -- invest in board training -- fund raising cannot override need to comply with basic organization rules.
 - b. Provide continuing education to all board members on their roles and responsibilities.
 - c. Establish sound personnel policies and periodically review them.
 - d. Adopt a conflict-of-interest policy for board members and staff -- each board member should sign annual statement as to other groups or entities that are affiliated with, work with, serve on, or such.

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2. Board Members.
 - a. Have clear understanding of activities that organization is allowed to carry out.
 - b. Understand board members' legal responsibilities. Have copies of governing rules -- articles of incorporation, bylaws, and related documents.
 - c. Make sure your organization complies with federal and state laws.
 - d. Review personnel policies carefully.

Board Members (continued)

- e. Attend board and committee meetings -- lack of attendance can be basis for liability. Can you realistically attend and participate in process -- if not, resign or not accept position.
- f. Read financial statements and other reports -- is it adequate and sufficient; if not, solicit information that will adequately answer concerns.
- g. Question inconsistencies or problems -- do not defer to the judgment of others.
- h. Ensure that accurate minutes are kept on board decisions, **including records of dissent** -- require adequate and proper notice of proposed action.

Board Members (continued)

- i. Avoid conflicts of interest -- disclose a conflict if it may be there -- err on side of disclosure.
- j. Always act in the organization's best interest.
- k. Fulfill any specific duties required by the organization's bylaws or other policy statements.
- l. Is okay to delegate responsibility, but must act prudently and diligently in selecting agents.

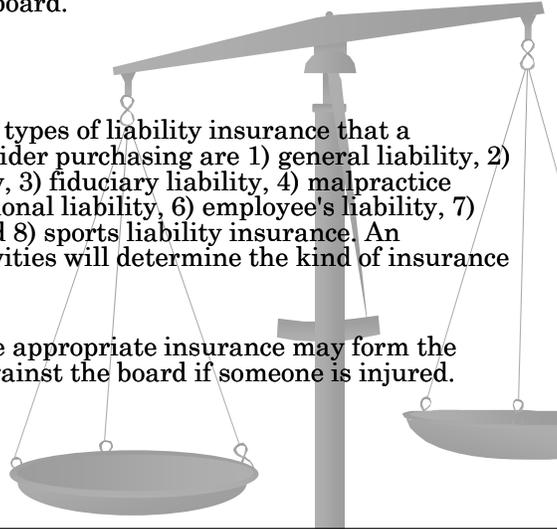


D. General and Other Liability Insurance

A nonprofit organization can purchase a variety of types of liability insurance to cover certain claims brought against it and sometimes against its board.

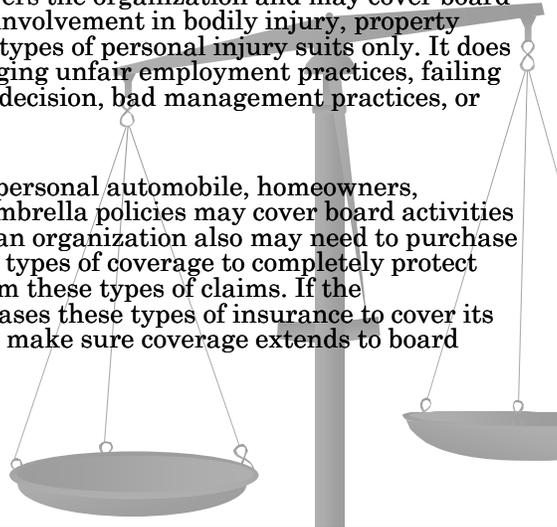
1. Organizational.

- a. Among the various types of liability insurance that a nonprofit may consider purchasing are 1) general liability, 2) automobile liability, 3) fiduciary liability, 4) malpractice liability, 5) professional liability, 6) employee's liability, 7) excess liability, and 8) sports liability insurance. An organization's activities will determine the kind of insurance required.
- b. Failure to purchase appropriate insurance may form the basis for a claim against the board if someone is injured.



2. Board Members.

- a. General liability insurance is purchased on behalf of an organization. It covers the organization and may cover board members for their involvement in bodily injury, property damage, and some types of personal injury suits only. It does not cover suits alleging unfair employment practices, failing to make a prudent decision, bad management practices, or others.
- b. A board member's personal automobile, homeowners, malpractice, and umbrella policies may cover board activities in some cases, but an organization also may need to purchase extensions to these types of coverage to completely protect board members from these types of claims. If the organization purchases these types of insurance to cover its activities, it should make sure coverage extends to board members.

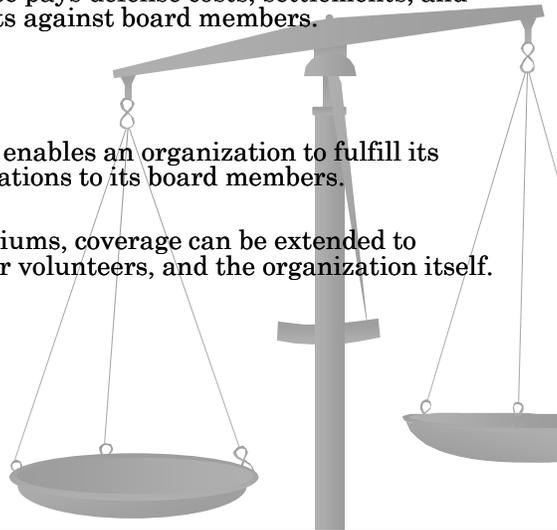


E. Directors' and Officers' ("D&O") Liability Insurance.

D & O liability insurance pays defense costs, settlements, and judgments for some suits against board members.

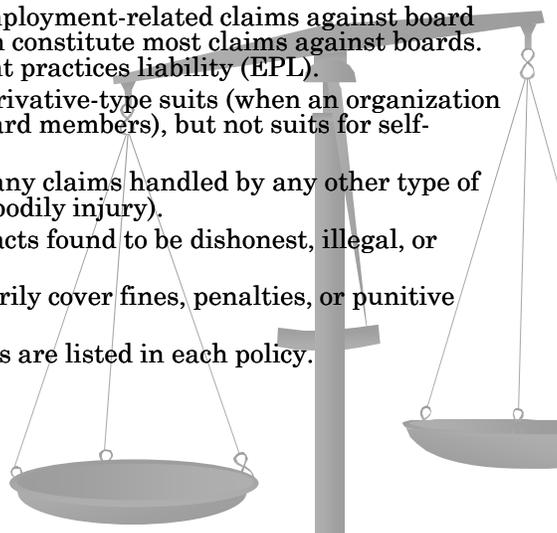
1. Organizational.

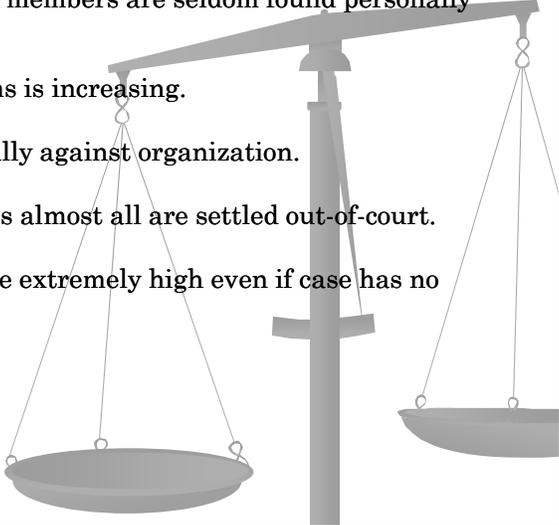
- a. D&O insurance enables an organization to fulfill its indemnity obligations to its board members.
- b. For added premiums, coverage can be extended to employees, other volunteers, and the organization itself.



2. Board Members.

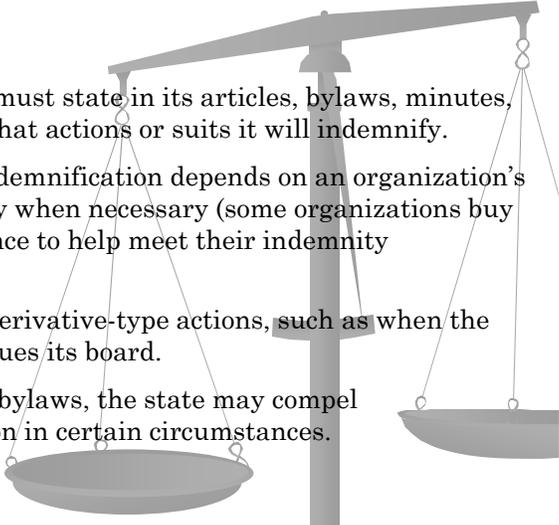
- a. Protects board members from an organization's inability to indemnify.
- b. Covers some employment-related claims against board members, which constitute most claims against boards. Add employment practices liability (EPL).
- c. Covers some derivative-type suits (when an organization sues its own board members), but not suits for self-dealing.
- d. Does not cover any claims handled by any other type of insurance (e.g. bodily injury).
- e. Does not cover acts found to be dishonest, illegal, or discriminatory.
- f. Does not ordinarily cover fines, penalties, or punitive damages.
- g. Other exclusions are listed in each policy.



3. *Current Trends in D & O Insurance.* As high as 90% of claims involve employment-related issues (discrimination, harassment, and wrongful termination).
- b. Volunteer board members are seldom found personally liable.
 - c. Number of claims is increasing.
 - d. Suits are generally against organization.
 - e. Little case law as almost all are settled out-of-court.
 - f. Defense costs are extremely high even if case has no merit.
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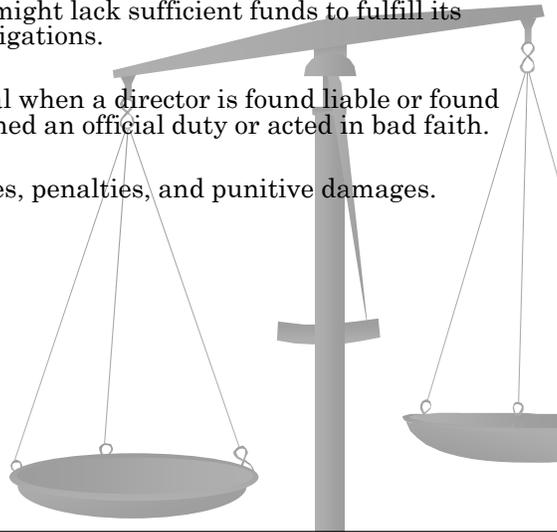
F. Indemnification: Indemnification means that an organization will pay, with its own resources, the legal costs, judgments, and settlements of suits (brought by third parties) against its board members.

1. *Organizational.*

- a. Organization must state in its articles, bylaws, minutes, or contracts what actions or suits it will indemnify.
 - b. In practice, indemnification depends on an organization's capacity to pay when necessary (some organizations buy D & O insurance to help meet their indemnity obligations).
 - c. Not legal for derivative-type actions, such as when the organization sues its board.
 - d. Even if not in bylaws, the state may compel indemnification in certain circumstances.
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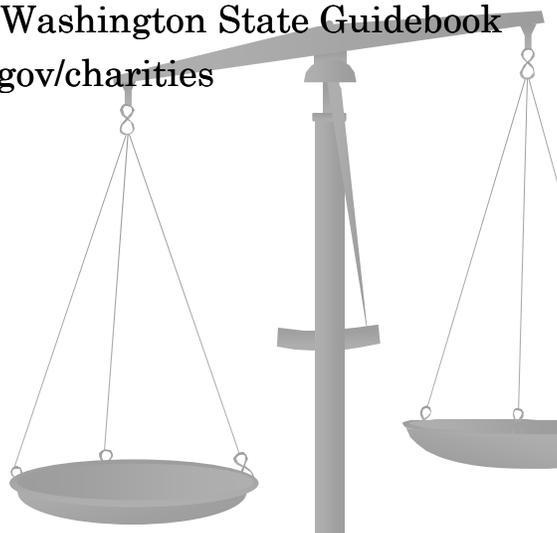
2. Board Members.

- a. Board members should be aware that a nonprofit organization might lack sufficient funds to fulfill its indemnity obligations.
- b. Often not legal when a director is found liable or found to have breached an official duty or acted in bad faith.
- c. Can cover fines, penalties, and punitive damages.



Charity and Nonprofit

- Board Service in Washington State Guidebook
- See www.sos.wa.gov/charities



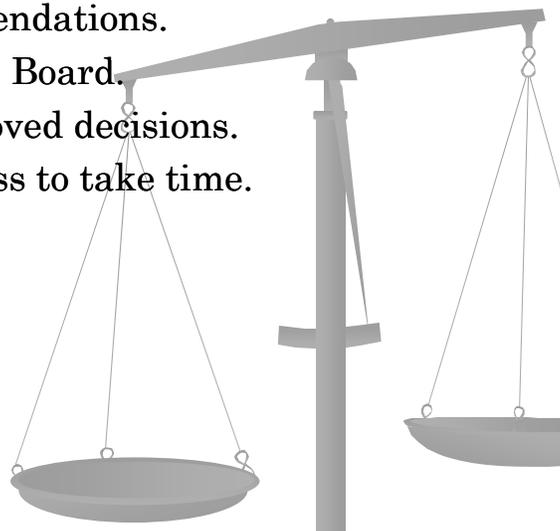
How to Conduct a Governance Review

- Appoint a committee.
- Decide on the objective of the review.
- Gather information.
- Seek input from relevant stakeholders.



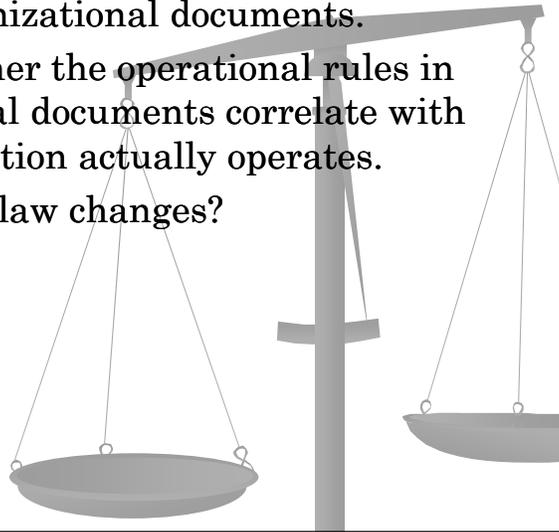
How to Conduct a Governance Review (cont.)

- Develop recommendations.
- Report to the full Board.
- Implement approved decisions.
- Expect the process to take time.



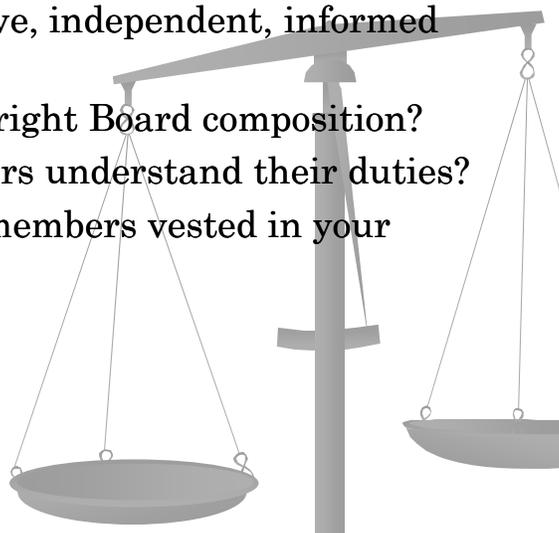
Governance Review – Legal Framework

- Review key organizational documents.
- Determine whether the operational rules in the organizational documents correlate with how the organization actually operates.
- Have there been law changes?



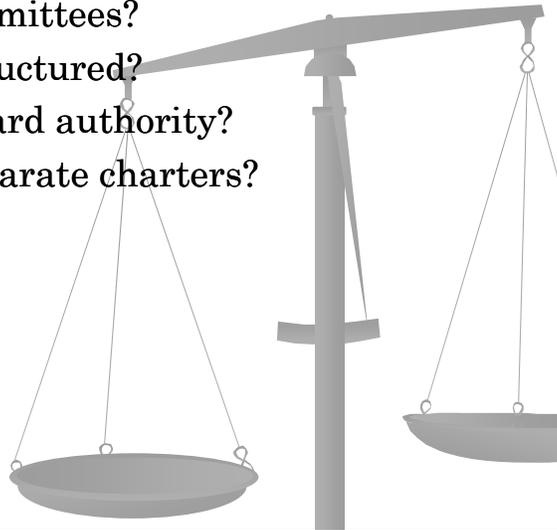
Governance Review – Board

- Do you have active, independent, informed Board members?
- Do you have the right Board composition?
- Do Board members understand their duties?
- Are your Board members vested in your mission?



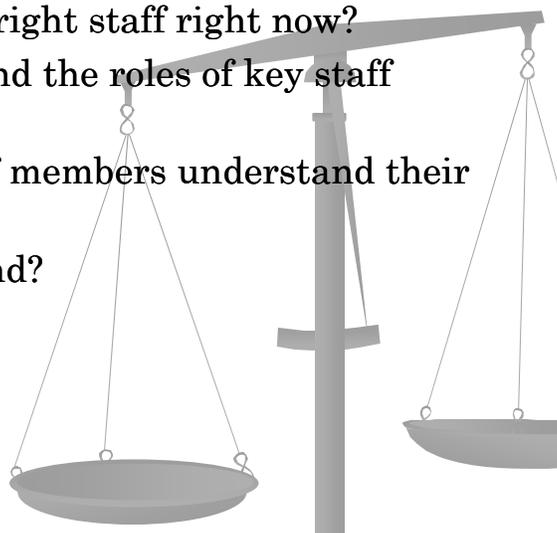
Governance Review – Committees

- Do you have committees?
- How are they structured?
- Do they have Board authority?
- Do they have separate charters?



Governance Review – Staff

- Do you have the right staff right now?
- Do you understand the roles of key staff members?
- Do your key staff members understand their roles?
- Chain of command?



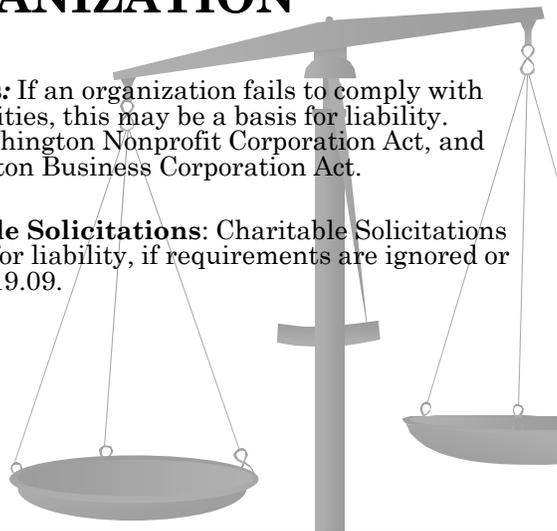
Policies and Procedures

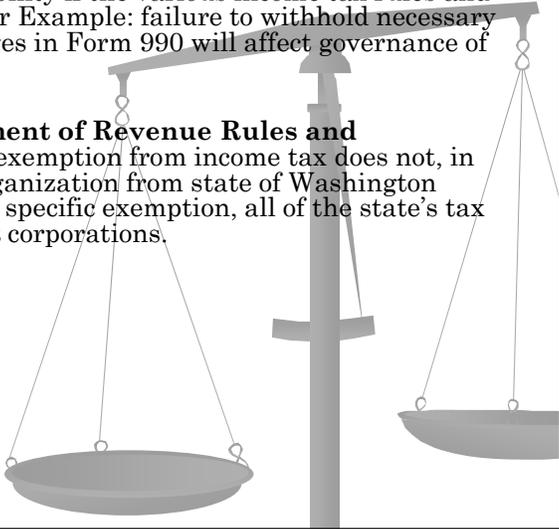
- What policies do you have?
- What policies do you need?
- What policies are required?
- Are you complying with your policies?



OTHER LIABILITY CONCERNS FOR THE BOARD AND ORGANIZATION

- A. **Corporate Formalities:** If an organization fails to comply with general corporate formalities, this may be a basis for liability. RCW chapter 24.03, Washington Nonprofit Corporation Act, and RCW title 23B, Washington Business Corporation Act.
- B. **Fundraising/Charitable Solicitations:** Charitable Solicitations can be an ongoing basis for liability, if requirements are ignored or not met. RCW Chapter 19.09.



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- C. Internal Revenue Code of 1986:** There is a possibility for significant personal liability if the various income tax rules and regulations not met. For Example: failure to withhold necessary taxes. Extensive changes in Form 990 will affect governance of exempt organizations.
- D. Washington Department of Revenue Rules and Regulations:** Federal exemption from income tax does not, in any way, exempt an organization from state of Washington taxes. Unless there is a specific exemption, all of the state's tax rules apply to nonprofit corporations.

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- E. Health and Safety Codes:** OSHA and WSHA impose the same obligations on non-profit entities as for profit ones.
- F. Employment Practices:**
- Fair Labor Standards Act
 - Employee Retirement Income Security Act
 - Antidiscrimination laws—age, sex, race, disability, religion, nation of origin
 - Family and Medical Leave Act/WA Family Case Act
 - Workers Compensation
- G. Antitrust Laws:**
- price fixing
 - exclusive dealing
 - monopolization