

Northwest Colorado Rural Philanthropy Days

Steamboat Springs, Colorado

Workshop: Legal Requirements and Ethical Issues for Nonprofits

Presented by: Sara Craig-Scheckman, Executive Director of the Craig-Scheckman Family Foundation

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Opening Questions

- Who is legally responsible for a particular nonprofit corporation?
- What does the Executive Director do and what does the board of directors do?
- Why do legal and ethical issues matter?
- Why does following best practices of nonprofit corporate governance make a particular nonprofit organization more competitive in fundraising?

Introduction to Legal and Ethical Requirements

A series of Wall Street corporate scandals (of which the Enron debacle is the poster child) put standards of corporate governance in the spotlight and led to the swift adoption of the Sarbanes-Oxley Act of 2002. The mandatory Act introduced major changes to the regulation of financial practice and corporate governance for for-profit corporate businesses. The Act established new standards of conduct in matters such as auditor independence, financial statement review, insider transactions and disclosure in both the for-profit and nonprofit sectors.

The Sarbanes-Oxley Act has greatly influenced the nonprofit world and led to the implementation of “best practices” to clarify and enhance nonprofit corporate responsibility and governance. Best practices reflect evolving trends in nonprofit governance and law.¹ Best practices help nonprofits maintain public confidence and avoid liability. Additionally, donors, regulators, community members and other nonprofit constituents may ask for assurance that nonprofit boards are doing their jobs, consistent with current standards and applicable law. However, it is important to note that best practices are goals and guidelines, not legal requirements per se.

At the state and federal levels, there is a movement toward increased government regulation of nonprofits. Increasingly, laws are being developed to regulate nonprofits in a manner similar to the 2002 Sarbanes-Oxley Act that governs the private sector. Furthermore, all Colorado nonprofit

¹ McDermott, Will & Emery, *Best Practices: Nonprofit Corporate Governance* (2004)

organizations must be aware of and in compliance with all legal requirements pertaining to nonprofit management, reporting, and governance.

Legal and ethical compliance is an essential best practice for all nonprofit organizations, especially now as competition for funding and scrutiny has increased. There are several sources of “best practices” that nonprofit boards can follow, such as the “best practices” of the for-profit sector or those recommended by independent or governmental organization specifically for the nonprofit sector.

In any case, directors of a nonprofit organization are subject to two primary fiduciary obligations to their organization: a duty of care and a duty of loyalty. The duty of care and the duty of loyalty are legal requirements derived from a century of litigation principally involving business corporations, but are increasingly applicable to nonprofit corporations.

Duty of Care

The duty of care has been described by Delaware courts as the duty of directors to “inform themselves, prior to making a business decision, of all material information reasonably available to them” and to “act with requisite care in the discharge of their duties.”² This duty of care as established by case law requires that, first, a director be informed, and second, a director discharge his or her duties in good faith, with care that an ordinarily prudent person in a like position would reasonably believe appropriate under similar circumstances. Courts of law have been deferential to the decision-making of properly functioning boards in the for-profit sector which exhibit compliance with the duty of care, and apply the “business judgment rule,” which largely precludes courts from second guessing directors’ decisions as long as they are rational, not self-interested, and made in good faith on an informed basis.³

Historically, nonprofit charities were formed as trusts, and the trustees managing the affairs of the organization were held to a much stricter standard of care, and the findings of ordinary negligence resulted in personal liability. Later, charities were incorporated as nonprofit organizations, like the 501(c)(3). Many courts began to apply the corporate standard of care to nonprofit directors, a level of care that goes hand in hand with the business judgment rule.

A nonprofit director cannot be a mere figurehead. All directors need to participate in all matters coming before the board. The following are practical suggestions of how directors of nonprofits can demonstrate “good faith.”⁴

- **Be proactive.** Directors should ask questions about important matters, even if the matters are not on the agenda.

² *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)

³ *In re Caremark Int’l*, 698 A.2d 959, 967 (Del. Ch. 1996).

⁴ Morrison & Foerster LLP, Boardroom Best Practices are Changing: the need to Demonstrate “Good Faith,” Corporate Board Advisory Issue No. 2 (September 2003).

- Obtain and review material information. Directors should strive to obtain all material information reasonably available to them.
- Receive and review relevant materials prior to the meeting. Directors should receive and review prior to the meeting an agenda and copies of all relevant documentation.
- Seek the advice of experts (legal, financial, accounting, etc.) where appropriate. The board should engage the expert.
- Take sufficient time for discussion and deliberation at board meetings. It is important to provide each board member with enough time to present his or her views and to ask questions.
- Document the process; record adequate minutes. Board and committee meeting minutes should reflect the deliberative process of the directors. Even where the board ultimately resolves to take no action, the record should reflect the board's effort and time in reviewing the issue.

Duty of loyalty

The duty of loyalty, as established by case law and statutory provisions, imposes an obligation on directors to set aside personal concerns and make decisions that are in the best interests of the organization, and primarily relates to: i) conflicts of interest, (ii) corporate opportunity and (iii) confidentiality.⁵

- Conflicts of interests involving a director are not inherently illegal nor will the result in a breach of the director's loyalty, if certain requirements have been met, such as: (1) the transaction was approved by a disinterested majority of the board, 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 nonprofit corporation at the time it was entered into.
- In terms of corporate opportunity, before a director engages in a transaction which the director reasonably should know may be of interest to the nonprofit, the director should disclose the transaction to the board in sufficient detail and in adequate time to enable the board to act or decline with regard to the transaction.

⁵ American Bar Association Section of Business Law, *GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS*, at 29-34 (2002).

- With respect to confidentiality, a director should not disclose information about the corporation's legitimate activities unless they are already known by the public or are of public record.

The obligation and loyalty of any nonprofit board director is to the entity itself, not directly to the executive director or the founder. There must be a clear understanding on this point, because without it the director will not be able to serve the best interests of the organization. In general, there must be a shared understanding between all the board directors, staff, and the executive director as to what is expected and required of the board. Many nonprofits implement a "Policies and Procedures" handbook or develop an agency manual on this point. Nonprofits also develop bylaws, which help guide the governance of the organization by the board.

Nonprofit directors also owe a "duty of obedience," a subset of the duty of loyalty, which is the obligation of a director to keep the organization within the stated bounds of its mission.⁶ This duty of obedience is a legacy of trust law that does not have an equivalent in the for-profit corporate law, and resembles the trustee's duty to be faithful to the purposes and goals of the organization.

Principles & Practices for Nonprofit Excellence in Colorado *please refer to handout*

In 2007 The Colorado Nonprofit Association developed these principles and practices, with the guidance of many of Colorado's leaders from the nonprofit, government and private sectors. The ongoing goal is to help charitable organizations build their capacity while enabling them to demonstrate their accountability and transparency. The principles and practices are meant to be flexible to allow for differences between large and small organizations, and will be most useful for Colorado nonprofit corporations that are tax-exempt under section 501(c)(3) of the Internal Revenue Code and are public charities.

Review and Discuss relevant sections on:

- Legal Accountability
- Governance
- Risk Management
- Transparency and Accountability
- Financial Management

⁶ Some commentators state that this is a duty separate from the duty of care and duty of loyalty. American Section of Business Law, NONPROFIT GOVERNANCE AND MANAGEMENT, 88 (2002).

Implementing board policy through best practices of nonprofit corporate governance⁷

A.: Board determines the organization's mission, sets policy, and assesses and approves programs and services that are appropriate to that mission.

- Implementing Best Practices:

- Possible Ethical Dilemma

B: Board membership is well managed.

- Implementing Best Practices:

- Possible Ethical Dilemma:

C: Board ensures that the organization is in compliance with regulations affecting nonprofit organizations and has sound risk-management practices.

- Implementing Best Practices:

- Possible Ethical Dilemma

⁷ BEST PRACTICES FOR NONPROFIT ORGANIZATIONS, Whatcom Council of Nonprofits (2004)

D: Board holds itself accountable for raising money.

- Implementing Best Practices:

- Possible Ethical Dilemma:

E: Board ensures effective fiscal management.

- Implementing Best Practices:

- Possible Ethical Dilemma:

F: Board represents the organization in the community.

- Implementing Best Practices:

- Possible Ethical Dilemma:

G: Board ensures that the public has reasonable access to information about mission, activities, board membership and basic financial data

- Implementing Best Practices:

- Possible Ethical Dilemma:

H: Board recruits, hires, sets salary, and evaluates the performance of the Executive Director and oversees succession of that position and other key staff.

- Implementing Best Practices:

- Possible Ethical Dilemma:

Closing notes regarding Best Practices

To review, best practices in the nonprofit sector are based on fundamental values of quality, responsibility, efficiency, transparency, and accountability. Best practices may help a nonprofit avoid legal liability. Furthermore, implementation of best practices can help ensure the sustainability of the nonprofit, increase community support, and lead to better fundraising opportunities. However, it is important to emphasize that although best practices for the nonprofit sector have emerged from the Sarbanes-Oxley Act and case law, best practices are guidelines, not legal requirements per se. A decision by a nonprofit to not adopt these best practices does not indicate an automatic breach of fiduciary duty.⁸

⁸ McDermott, Will & Emery *Best Practices: Nonprofit Corporate Governance* (2004)

Resources

American Bar Association Section of Business Law, *GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS*, (2002)

Colorado Nonprofit Association, *Principles & Practices for Nonprofit Excellence in Colorado* (2007)

Continuing Legal Education in Colorado, *Guide for Colorado Nonprofit Organizations*, (2007)

Deloitte, *The Risk Intelligent Board: Viewing the World through Risk-Colored Glasses*, Risk Intelligence Series, Issue No. 12

McDermott, Will, & Emery, *Best Practices: Nonprofit Corporate Governance*, (2004) website:
www.mwe.com/info/news/wpo6o4a.pdf

Minnesota Council of Nonprofits, *Principles and Practices for Nonprofit Excellence* website:
mncn.org/info_principles.html

The Sarbanes-Oxley Act, 15 U.S.C. 7201 *et. seq.*

Whatcom Council of Nonprofits, *Best Practices for Executive Directors and Boards of Nonprofit Organizations*