ARNOLD & PORTER LLP

GOVERNANCE

AN OVERVIEW

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Fiduciary Duties: The General Rule

- A director owes a fiduciary duty to the nonprofit corporation ("Corporation") on whose board he or she serves.
- In performing his or her duties, a director must act in the best interests of the Corporation (e.g., work to fulfill the Corporation's tax-exempt purposes and maintain its tax-exempt status).
- The director may not act in a way that is detrimental to the Corporation in an effort to benefit any third party.
  - The director must disclose to the other members of the Board of the Corporation when the Board's actions may have a material impact on the director or another corporation or entity in which the director has a financial interest.
  - The director must not participate in any Board discussion or vote on such issues, unless the Board determines that the director may so participate.
  - If the Board determines that the director may participate, the director may still decide that a conflict exists and that he or she should not participate in any discussion or vote.

Fiduciary Duties That a Director Owes to the Corporation

- The duties that a director owes the Corporation are the *duty of obedience,* the *duty of care* and the *duty of loyalty*.
- In general, under the "business judgment rule," if a Board of Directors properly exercises these duties, its members generally will be protected from liability for their actions on the Board.
  - In effect, there is a presumption that, in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interest of the Corporation, even if the Board's decisions lead to a "bad" outcome.
  - This presumption can be overcome with a showing that the Board acted with gross negligence.

Duty of Obedience

- The directors of the Corporation must not engage in *ultra vires* acts – acts that the Corporation, under its charter and applicable law, cannot perform because such acts are prohibited or beyond the scope of the Corporation's powers.
- The Board should also take into consideration any donor restrictions in exercising their duty of obedience.

Duty of Care

- The duty of care generally describes the level of attention required of a director in all matters related to the Corporation.
- The duty of care is perhaps more accurately described as a "duty to be informed."
- A director has the responsibility to be informed about an issue before making a business decision relating to the issue.
  - A director will fulfill the duty of care if, prior to making a decision, he or she considers all material information reasonably available to him or her.
  - To fulfill the duty of care, the directors of a Corporation should follow deliberate procedures and consult with appropriate committees, officers, or employees of the Corporation or other outside experts in making corporate decisions.

Duty of Loyalty

- The duty of loyalty requires a director to act *solely* in the best interests of the Corporation rather than in his or her own interests, or those of his or her associates.
- The duty of loyalty also encompasses a director’s obligation to avoid conflicts of interest.
  - For a director, a violation of this duty may result in personal liability for a breach of fiduciary duty.
- For the Corporation, such a breach may allow a court to void the corporate transaction in which a conflict was present.
- Another important aspect of the duty of loyalty is to maintain the confidentiality of information that is explicitly deemed confidential by the Corporation, as well as information that appears to be confidential from its nature or matter.

Conflicts of Interest

- In general, a conflict of interest with a director exists when the Corporation does business with:
  - a director of the Corporation;
  - another entity in which a director of the Corporation is also a trustee, director, officer, employee, consultant, or agent; or
  - another entity in which a director has a financial interest (a "financial interest" can generally be defined to include an ownership or investment interest in the entity with which the Corporation is contracting, or a compensation arrangement with such entity).

Conflicts of Interest, cont'd

- To avoid even the appearance of a conflict of interest, a director may want to treat as a conflict a transaction between the Corporation and
  - the director's spouse or domestic partner, or the director's siblings, descendants, or ascendants (as well as the spouse or domestic partner of any sibling, descendant or ascendant),
  - any entity in which such a relative is a trustee, director, officer, employee, consultant, or agent, or
  - any entity in which such a relative has a financial interest.
- In addition, the Corporation should have its own conflict of interest policy that must be followed.
  - Indeed, on the federal tax return (Form 990), certain tax-exempt organizations, including public charities, are required to disclose whether they have a written conflict of interest policy and how that policy is administered.

Conflicts of Interest, cont'd

- If a conflict of interest is or may be present, the effected director should:
  - Disclose to the Board of Directors or relevant committee of the Board the material facts as to his or her relationship or interest.
  - Not participate in any Board discussion or vote, unless the Corporation's board determines that the director may participate in such discussion or vote.
- If the Board determines that the director may participate, the director may still decide that a conflict exists and that he or she should not participate in any discussion or vote.
- If a director follows these disclosure and recusal procedures, a party challenging a transaction on the grounds of a conflict of interest/breach of fiduciary duty will face a heightened burden.

Asset Management

- One of the most important duties of a Board is the management of the Corporation's assets (financial, human and property, including intellectual property).
  - Hiring, appropriately compensating, supervising and evaluating the CEO and, to some degree, senior management.
  - Ensuring that the organization is appropriately staffed and well managed.
  - Protecting and using IP and other assets wisely.

Investment Standards

- The Board must manage and invest the Corporation's funds consistent with its duty of loyalty, in good faith, and with the care that an ordinary prudent person would exercise.
  - Investment experts, whether in-house or outside advisors, are held to a standard of care consistent with their expertise.
- To help determine what this means, all states, except Pennsylvania, have adopted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"), some with variations.

UPMIFA Highlights

- The Board may make decisions on expenditures, using a prudent total return standard.
- The Board and financial managers are not limited in the kinds of assets that they can include in the portfolio.
- Investment costs must be reasonable, taking into consideration the assets, the purpose of the Corporation and its financial expertise.
- UPMIFA does away with the historic dollar value limitations on spending from endowed funds.
- States may adopt a rebuttable presumption of <u>imprudence</u> if an institution spends greater than 7% of the fair market value of a fund, using a 3-year average.

Standard of Care

- In managing and investing under UPMIFA's prudent, total return standard, the Board should consider:
  - General economic conditions
  - Inflation or deflation
  - Overall portfolio and other resources of the Corporation
  - Expected total return from income and appreciation
  - Investment and spending policy of the Corporation
  - Financial needs of the Corporation
  - Restrictions imposed by donors
  - Legal considerations (e.g., tax consequences, self-dealing rules, excess business holdings, jeopardy investments)
  - The charitable purposes of the Corporation

Standard of Conduct, cont'd

- Bottom line, management and investment decisions about individual assets should take into consideration the overall portfolio, the overall investment strategy (including the risk and return objectives of the portfolio) and the charitable purposes of the Corporation and the individual assets involved.

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This summary is intended to be a general summary of the law and does not constitute legal advice. You should consult with competent counsel to determine applicable legal requirements in a specific fact situation.