

ARNOLD & PORTER LLP

# What's Keeping You Up at Night? Hot Topics in Non-Profit Governance

November 14, 2014

DRIVING EXCELLENCE IN CORPORATE GOVERNANCE

[arnoldporter.com](http://arnoldporter.com)



## Role of the General Counsel in Governance

- In governance, the role of the General Counsel (and outside counsel) is multi-fold:
  - Counsel to the organization
  - Advisor to the Board
  - Advisor to management
  - Chief Compliance Officer
  - Taskmaster
  - Traffic cop
  - Referee
  - Psychologist

## Board of Directors

- The Board is . . .
  - independent
  - in charge
- The Board complies with . . .
  - the law
  - fiduciary duties
  - Bylaws
  - corporate policies
- Counsel helps to ensure that all these things happen.

## **Fiduciary Duties: You Know the Basics**

- A director owes a fiduciary duty to the nonprofit organization (“Organization”).
- In performing his or her duties, a director must act in the best interests of the Organization (e.g., work to fulfill the Organization’s tax-exempt purposes and maintain its tax-exempt status).

## Fiduciary Duties: Duties of Obedience and Care

- Obedience

- The directors of the Organization 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.

- Care

- Devote time, exercise ordinary diligence, and use reasonable judgment to ensure the Organization is run prudently and with due regard for its tax-exempt purposes

## Fiduciary Duties: Duty of Care and Financial Management Obligations

- In general, under the “business judgment rule,” if a board of directors properly exercises the fiduciary duties discussed above, its members 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 Organization.**
- This presumption can be overcome with a showing that the board acted with gross negligence.
- Despite the relatively significant burden of trying to prove gross negligence by a nonprofit director, and despite the protections of the business judgment rule, nonprofit directors can be held responsible when an organization’s finances are poorly managed.



## Fiduciary Duties: Duty of Care and Financial Management Obligations (cont'd)

- This type of mismanagement is characterized by a pattern of actions or inactions that result in significant harm over a period of time.
  - [Lynch v. John H. Redfield Foundation, 88 Cal. Rptr. 86\(Cal. Ct. App.1970\)](#), the directors of a foundation allowed the organization's income to accumulate in non-interest bearing accounts for over five years. This investment decision was made as a result of long-term disagreements among the directors that resulted in their inability to productively manage the foundation's assets.
  - As stated by the court: "All three directors, in concentrating on their feud, left the foundation in a state of suspended animation for several years, ignoring their obligations to carry on its charitable purposes and to manage its assets with a degree of care and diligence which a prudent man would exercise in the management of his own affairs." [Id.](#) at 88.

## Fiduciary Duties: Duty of Care and Financial Management Obligations (cont'd)

- A director must also act in “good faith”, which means an absence of any intent to take advantage of the Organization.
- It also means some level of diligence in actually seeking to discharge the director's responsibilities. General neglect in decision-making, therefore, would not be good faith.
- In the leading case, which involved Sibley Hospital in DC, *Stern et al. v Lucy Webb Hayes National Training School for Deaconesses and Missionaries, et al.*, 381 F. Supp. 1003 (D.D.C. 1974), the board of directors was found to have breached its fiduciary duty in part for allowing, through inaction and inattention, the reserve fund of the corporation to languish in investment vehicles that paid very low interest rates or no interest at all.



## Fiduciary Duties: Duty of Care and Financial Management Obligations (cont'd)

- Mismanagement of Investments. The duty of care includes, and in fact mandates, that the board protect the assets of the Organization. This includes the general management and investment of all of the Organization's funds.
- A Reasonable Plan. A board is not an insurer of the adequate performance of a Organization's funds in an investment vehicle, but investment decisions must be reasonable and defensible.
  - In Johnson v. Johnson, 516 A.2d 255 (N.J. Super. 1986), the dispute involved the investment of funds owned by two charitable foundations. After a detailed review of various investment approaches, the court concluded that the individual in charge of investments had pursued a reasonable investment strategy. Despite the fact that the defendant's investment approach was unsuccessful, the court found that the defendant acted reasonably.
- Outside Advice. Directors are not expected, or legally required, to be investment experts. Retention and reliance on an investment advisor with a good reputation is more than reasonable; it is an effective protection for the board, even if the advice given ultimately is flawed.
  - A nonprofit board's failed investment decisions did not violate its fiduciary duties where they were "based, in part, on research provided by the [organization's] analysts and conforming to guidelines set forth by various investment strategy groups composed of senior portfolio managers, who regularly monitored the suitability of equity investments and rate securities in various categories based upon performance." In the Matter of Bankers Trust Company, 636 N.Y.S.2d 741 (A.D.2d 1995).

## Fiduciary Duties: Duty of Care and Financial Management Obligations (cont'd)

- Oversight. In the vast majority of cases, nonprofit directors have incurred liability related to investments not because investments knowingly made simply underperformed, but rather, when the directors delegated investment responsibility to an individual or committee, and then failed to oversee or supervise that person/entity. See [\*Stern v. Lucy Webb Hayes National Training School For Deaconesses & Missionaries\*](#).
- Delegating or Abdicating Authority. While, it is not unusual for a nonprofit board to delegate investment responsibility (e.g., to a committee or individual director or staff member), boards should document such a delegation and be clear as to the scope of the delegation.
  - In [\*Hoye v. Meek\*](#), 795 F.2d 893 (10<sup>th</sup> Cir. 1986), the president of a company delegated investment responsibility to his son, also an employee of the company. While the son was subject to a board policy restricting investments to supposedly-safe government securities, he managed to make such investments in a very risky manner, with disastrous results. Although the President and other board members received monthly reports as to the finances of the organization, no action resulted from reviewing the reports that were provided. The court found the president liable for the losses.

## Fiduciary Duties: Duty of Loyalty

- The duty of loyalty requires a director to act *solely* in the best interests of the Organization rather than in his or her own interests, or those of his or her associates.
- One important aspect of the duty of loyalty is to retain the confidentiality of information that is explicitly deemed confidential by the Organization, as well as information that appears to be confidential from its nature or matter.
- 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 Organization, such a breach may allow a court to void the corporate transaction in which a conflict was present.



## Fiduciary Duties: Duty of Loyalty and Conflicts of Interest

- In general, a conflict of interest exists when the Organization does business with:
  - a director of the Organization;
  - another entity in which a director of the Organization 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 Organization is contracting, or a compensation arrangement with such entity).
- To avoid even the appearance of a conflict of interest, a director may want to treat as a conflict any transaction between the Organization and (i) 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 spouse, descendant or ascendant), (ii) any entity in which such a relative is a trustee, director, officer, employee, consultant, or agent, or (iii) any entity in which such a relative has a financial interest.
- In addition, the Organization should have its own conflict of interest policy that must be followed.
  - Indeed, on the federal tax return (Form 990), tax-exempt organizations are now required to disclose whether they have a written conflict of interest policy; report whether officers, directors or trustees, and key employees are required to disclose annually any interests that could give rise to conflicts; and describe how the organization monitors and enforces compliance with the conflict of interest policy
- If a conflict of interest is or may be present, the director must:
  - 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 Organization’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.

## The Role of General Counsel

- How do you educate a Board about its duties?
  - especially a Board that has high-powered, experienced and successful members,
  - who are used to being in charge, but
  - who might not know or understand the rules relating to nonprofits or the regulatory environment in (and level of scrutiny under) which nonprofits operate?
- It is important that the General Counsel, either directly or through the Board Chair or other Board members, understand the extent to which Board members understand their fiduciary duties. Look for “teachable moments” to make these rules clear to the Board.

## The Role of General Counsel

- Who do you report the Board to, or particular members, if they are not living up to their fiduciary duties?
- Technically, the GC is representing the best interests of the organization. This may mean that you have to go to the Chair, the CEO, or other Board members (Chair of Governance Committee if there is one) to discuss concerns.
- A lawyer may even have the responsibility of going to regulatory authorities (the State AG or IRS) if Board members are misbehaving.



## The Role of General Counsel

- Corporate policies – conflicts of interest, whistleblower and compensation, in particular – are filled with landmines for a GC.
- How, in a practical sense, do you deal with conflicts, especially among Board members who have their fingers in many pies and who don't take no for an answer?
  - It is important to have policies in place so you can rely on them and point to them when you need them.
  - Reminding Board members of their fiduciary duties, the reporting requirements on the Form 990 and state regulatory oversight might help.

## The Role of General Counsel

- What delicate dance must you do to balance the intermediate sanctions rules and the push for higher compensation by employees?
  - Board members can have personal liability for approving excessive compensation. This can be a compelling stick to get Board members to focus.
  - What about Board compensation? Board expenses (travel, dinners, etc)? Raising personal liability and personal reputational issues may help.
- Allegations of whistleblowers can be very complex and difficult to manage? Do you have a plan on how do you deal with these and when allegations are brought to the attention of the Board?

## **The Role of General Counsel: Some Additional Questions**

- How do you assist the Board in “overseeing” but not “micro-managing?”
- What role do you play in the Board’s review of management?
- To what extent do you have a direct reporting relationship to the Board, and does this create tensions with your CEO?
- Does the Board ever retain its own counsel? Have you ever recommended it hire its own counsel? If you represent the Organization, how do you interact with the Board’s counsel?



## **The Role of General Counsel: Some Additional Questions**

- How has the “new” Form 990 changed governance?
- Do you have a process to identify conflicts that must be reported on the 990 as soon as they occur?
- Do you set compensation, travel policies and the rules for related-party transactions with 990 disclosure in mind?

## **The Role of General Counsel: Some Additional Questions**

- In making decisions, do you think about the reaction of Congress? The press? State AGs? Government customers? Others?
- How do you decide when it is appropriate to bring information to the attention of the Board?
- Is this decided with input from the CEO? The Board Chair? Both? Others?

## The Role of General Counsel

- And last but not least....

What does keep  
you up at night?