THE AMERICAN SPEECH-LANGUAGE-HEARING ASSOCIATION

LEGAL RESPONSIBILITIES OF MEMBERS OF THE BOARDS OF NONPROFIT ASSOCIATIONS

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I. OVERVIEW

A. The Legal Responsibilities of Being a Member of the Board

Individuals who serve on the boards of an association often perform several other roles. A board member may be the head of an academic program, the director of a private clinic, or a teacher in the public schools. The purpose of this presentation is to help sort out the responsibilities of serving on a board from the responsibility accompanying different roles. A clear understanding of "for what" a board member is responsible and "to whom" will not only help avoid lawsuits and liability, but will make the board function more effectively.

B. Application of Corporate Law Principles

The actions of the members of a board of a nonprofit association are reviewed, applying the same legal standards applied to actions of members of boards of directors of for-profit corporations. In fact, many states, including Kansas, simply apply their for-profit corporate code to nonprofit associations, with certain modifications. As will be discussed in this outline, however, the standards of conduct are interpreted to accommodate the unique purposes of nonprofit associations and the roles of their boards.

This presentation will, therefore, discuss:

- The board members' responsibility: WHAT ARE THE BOARD'S DUTIES?
- To whom is the board responsible: WHO CAN SUE AND WHY?
- What steps can be taken to minimize the risks and responsibilities of serving on the Board: WHAT SAFEGUARDS AND PROTECTION ARE AVAILABLE?

II. BOARD MEMBERS' DUTIES TO THE ASSOCIATION

Board members owe their association fiduciary duties of **care, loyalty, and fidelity to purpose**. Each of the duties discussed in more detail below must be carried out with the same degree of care exercised by a reasonable, prudent person in the same position.

In carrying out each of the duties, board members will be entitled to the benefit of the doubt. They will be protected from being "second guessed" and being held personally liable for bad decisions, provided that the decision was properly reached. The source of this protection is the "Business Judgment Rule." Despite its name, the Rule applies to the "business" of decision-making by boards of nonprofit associations.

The Business Judgment Rule is related to all three fiduciary duties. It is based on the presumption that in making a decision affecting the association, the members of the board have acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the association. If all three aspects of this presumption are correct, any "business" decision made by the board members is accorded a high degree of respect.

A. Duty of Care

1. The Standard. The duty of care focuses on the level of diligence exercised by the board member in carrying out his or her responsibilities. The Revised Model Business Corporation Act defines the duty of care as follows:

> A [board member] shall discharge his [or her] duties as a [board member], including his [or her] duties as a member of a committee (1) in good faith, (2) with the care an ordinary prudent person in like position would exercise under similar circumstances, and (3) in a maner he [or she] reasonably believes to be in the best interest of the [association].

The standard considers the "position" and "circumstances" and, therefore, will impose varying standards, depending upon the status of the individual board member and the nature of the action being evaluated. For example, board members are generally held to a higher standard when the action being questioned involves extraordinary or controversial action by the association, such as the purchase or sale of a major asset or any other major transaction not in the ordinary course of business.

The Case of the Bullish Boards

- *The Executive Board of the Instant Gratification Association ("IGA"), a nonprofit association, determines, based on their estimate of the Association's income and assets, that it should start investing in the stock market. At the suggestion of one headstrong Board member who asserts that there is no need to study everything to death ("We know what we* *want"), the Board determines to authorize the purchase of $2,000,000 worth of stock in Enron Corporation.*

- *The Executive Board of the Very Methodical Association, based on a report of management (national office staff) projecting the income assets and investments of the association, establishes a committee of the Board, and this committee, in conjunction with national office staff, contracts with a qualified independent investment consultant who reviews with them the stock market and the performance of various stocks. After considering the consultant's written recommendations, and the views of the national office staff, the committee recommends to the Board that the Association purchase stock of Enron Corporation. The Board discusses the committee's recommendation and decides to purchase the stock.*

ANALYSIS

Both Boards reached the same decision by different routes. Now assume that stock's value suddenly plummets; both Associations have lost its investment. The members of the Executive Board of both Associations are then sued for entering into a patently unfavorable investment.

Although the Boards reached the same decision, only the Very Methodical Board is likely to be shielded by the Business Judgment Rule. Their decision, although clearly wrong, was made on an informed basis with advice from an independent consultant, in good faith, and in the honest belief that it was in the Association's best interest. The Instant Gratification Board clearly did not make their decision "on an informed basis" because they failed to seek competent advice, and they failed to consider a range of options. These failures constitute a failure of the duty of care, and their action will not be protected by the Business Judgment Rule.

Moral: *If you are going to be wrong, do it after careful consideration.*

2. Steps to Help Satisfy the Standard of Care. A board can preserve the benefits of the Business Judgment Rule by following the general principles set forth below:

- **Retain competent help.** The law recognizes that members of a board cannot be experts in all areas in which they are required to make decisions. Retention of qualified experts (consultants, lawyers, accountants, appraisers) will help satisfy the standard of care. Use of legal counsel for internal audits of potential impropriety may also preserve privileged information from disclosure.

- **Rely on management.** State law (including that of Kansas) recognizes a board's need to rely on the advice and facts provided by the association's officers (e.g., the national office staff) who are more familiar with the day-to-day operations and needs of the association. Of course, such reliance must be reasonable, and directors must still exercise judgment in assessing recommendations of management.

- **Use committees.** All members of the board cannot be expected to be actively involved in all ongoing matters. Committees gather the most interested (and possibly most qualified) members of the board to address an issue. The board is permitted, under Kansas law, to rely on reasonable recommendations of committees.

- **Create a record of the decision-making process.** Board actions are usually questioned well after the fact. Proving satisfaction of the duty of care is easy if the members of the board can present detailed minutes of each committee and board meeting, with all reports, recommendations and factual data attached.

- **Promote open debate and record dissent.** Passive board members may be judged solely on their vote, while active board members can explain or support the basis of their vote, if the minutes reflect their views. Dissenting directors may request that their negative vote be recorded.

B. Duty of Loyalty

1. The Standard. The duty of loyalty is the board member's obligation to act in the association's best interests and not to use his or her authority to advance personal interests, or the interests of related third parties. These self-interests need not be financial, but may be such interests as enhancing prestige and professional reputation of oneself or one's employer. The phrases "conflict of interest" and "self-dealing" describe potential breaches of this duty.

Breaches of this duty most frequently arise in the context of a transaction between a nonprofit association and another party (e.g., seller, buyer, landlord or tenant), which is a member of the board, or a person (or entity) related to a member of the board, such as a family member, business associate, or a company controlled by the member of the board. For example, in *The Case of the Bullish Board* above, if the headstrong member of the Board recommending leasing space in the Newtown Office Park had a financial interest in that office development, his actions would be subject to scrutiny as a breach of his duty of loyalty. The protection of the Business Judgment Rule would be lost, and a court would require that the member of the Board show the intrinsic fairness of the transaction to the association. (Note: Such self-dealing does not necessarily subject the director to personal liability if it turns out that the association got a fair deal.)

A Concrete Example of Divided Loyalty

The Board of the Better Homebuilding Association, a nonprofit association dedicated to helping builders and designers obtain and distribute information on safe home building, is considering announcing to its members and the public their endorsement of poured concrete *foundations as safer and less subject to radon gas seepage. Solid Citizen, a long-standing member of the Board and advocate for the benefits of cement foundations, owns 40% of the stock of a large, multi-state cement distribution company, Central Cement, Inc. The public endorsement will clearly increase the company's revenues. Can he vote for the announcement? If so, how can he protect himself from allegations that he engaged in self-dealing?*

Another Board member asked to approve the endorsement in question is Faithful Servant, a mid-level employee of Central Cement, Inc. While he will not be directly enriched by the proposed announcement, his employer will be more successful, and his standing in the eyes of his superiors may be enhanced.

ANALYSIS

The permissible level of participation by "interested" Board members like Messrs. Citizen and Servant will depend on the circumstances. In the extreme case (e.g., if the association was to endorse a method used exclusively by Central Cement, Inc. as the best method for pouring foundations), the interested board member should disclose his or her interest in the decision and abstain from any deliberations, as well as the final vote. On the other extreme (e.g., a general criticism by the Better Housing Association of cinder block or wood foundation materials), the interested board member may chose to take the minimal precaution of disclosing to the board his or her interest, and otherwise participating in the decision.

2. Steps to Help Satisfy The Standard of Loyalty

- Board members should be conscious of the conflict between their personal interests and those of the association.

- Board members should consider articulating and disclosing any possible conflicting interest, both on a general level and as specific conflicts arise.

- Board members should consider not participating in the discussion and not voting if the conflict interest is either strong enough to actually influence the member, or may reasonably appear that way.

- Board members should consult with association counsel with respect to any questionable calls. This serves both purposes of obtaining helpful advice and demonstrating good faith in resolving the conflict.

A more difficult application of the duty of loyalty involves a board member (or a related person or entity) taking advantage of ("usurping") opportunities which would have been beneficial to the association. Returning to *The Case of The Bullish Board*, if one Board member on the office-space committee was aware of suitable office space at "bargain" prices, yet he wanted to use that space for his own business, he would face a potential conflict of interest. To satisfy the duty of loyalty, he is required to offer the office space to the Association first. Whether a breach actually occurs will depend on a number of factors, including the relationship between the opportunity and the nonprofit association's principal activities. Again, the safest route for a member of the board to take would be to make full disclosure of the opportunity to the association board, and allow the disinterested members of the board to determine the association's actions.

The Case of the Good Idea

Always Thinking, a member of the Board of the Association for Bioethical Thinking, is also the head of a prestigious hospital. A Task Force Report by an Ad Hoc Committee of the Association for Bioethical Thinking recommends that an interdisciplinary symposium on gene research be sponsored by the Association in a few months. Always Thinking believes that his hospital would want to sponsor such a program. The Hospital announces the program before the Association for Bioethical Thinking can decide if it wants to sponsor the program.

Always Thinking has violated his duty of loyalty to the Association by usurping an association opportunity.

3. Steps to Avoid Usurping Association Opportunities.

Whether an association board member has actually usurped an opportunity of the association will depend on a number of factors. After a board member has come in contact with a potential opportunity, he or she should consider the following factors:

- Is the opportunity one which the association would ordinarily be interested in, and does the association have the time and resources to take advantage of it?

- Has the association already expressed an interest in the opportunity, specifically or generally (e.g., formation of a special committee to study the opportunity)?

- Did the director come in contact with the opportunity in the course of his or her activities for the association, or has the director used (or will he or she use) association resources to procure the opportunity?

To the extent that these questions can be answered "yes," there is an increased likelihood that the board member is obligated to offer the opportunity to the association. Courts recognize that directors often wear many hats, and their fiduciary obligations to two or more organizations often conflict. Unfortunately, there are no black-and-white answers because circumstances vary and state courts have established a variety of "tests" for determining usurpation.

Another aspect of the duty of loyalty may be confidentiality. To the extent that matters are required to be held confidential, it may breach the duties of loyalty and due care not to do so.

The Case of Loose Lips Sinking Ships

The National Nautical Network ("NNN"), a nonprofit association dedicated to naval news, is about to adopt a new journal about sea-going vessels entitled "SHIPS." NNN wants to trademark the journal name. Blabber Mouth, a Board member of NNN, tells her friend, Very Speedy, the Executive Director of the Quick Reponders Association ("QRA"). QRA beats NNN out with a publication entitled "SHIPS." Blabber Mouth has breached her duty of loyalty to NNN.

C. Duty of Fidelity to Purpose

1. The Standard. A board member's duty of fidelity to purpose (often called the duty of obedience) is particularly important in the context of nonprofit associations because it involves the board member's fidelity to the purposes of the association. This duty is particularly important when an association obtains public funding based on representations of its goals and purposes. Unlike for-profit corporations, nonprofit associations generally are required to designate a purpose and must adhere to that purpose in order to retain the privileges of a nonprofit association.

The Case of the Board Straying from Its Foundation

The Executive Board of the Better Advice Giver's Association, after 75 years of operation, becomes dominated by advice givers located in Region Y, where there is a large number of advice givers already in practice. Because the members of the Board feel that there are too many advice givers in Region Y, they rarely approve applications from new Region Y advice givers seeking certification. In effect, the Executive Board of the Association has become a tool for eliminating competition for its members and increasing their economic benefits, to the clear detriment of candidates for certification.

ANALYSIS

The directors of the Association have breached the duty of fidelity to purpose by abandoning the impartial consideration of applicants seeking certification intended by the Association's founders.

1. Steps to Help Satisfy The Standard.

- Board members should review the dedicated purposes of the association.
- Board members should continuously examine, together with the leadership and the national office staff, whether proposed actions are designed to meet the association's purposes.
- Board members should annually review activities for conformity with the association's self-espoused objectives.

Breaches of the duty of fidelity to purpose can be more subtle than *The Case of the Board Straying From its Foundation*, in which a nonprofit association is used for personal gain. For example, the Executive Board may be dominated by advice givers who adhere to the X School of Thought and who tend to deny certification to applicants adhering to the Z School of Thought, thus breaching the duty of fidelity to the impartial certification of practitioners of all schools of thought.

III. BOARD MEMBERS' RELATIONSHIP WITH MEMBERS OR THOSE DEALING WITH THE ASSOCIATION: WHO CAN SUE, AND WHY?

Lawsuits against board members of nonprofit associations break down into two general classes: suits filed on behalf of the association itself ("derivative suits") and suits filed by persons harmed by acts of the association or its agents ("third-party suits"). A distinction must be made between lawsuits against the association and lawsuits against individual members of the association's board. We are only considering the second type here.

A. Derivative Suits

Much like for-profit corporations, board members of nonprofit associations are subject to lawsuits filed by or on behalf of the association. In theory, the plaintiff is suing for harm suffered by the association and, therefore, the plaintiff must have some unique interest in the association. Shareholders of for-profit corporations are generally the party filing derivative actions. Because nonprofit associations have no shareholders, the list of potential plaintiffs capable of suing on behalf of the association is smaller. Nevertheless, any individual or entity that can show a significant relationship with the nonprofit association can sue on its behalf. Board members of nonprofit associations may be sued derivatively by (1) fellow board members, (2) the State Attorney General (suing on behalf of the state which incorporated the association), (3) the members (who are comparable to shareholders in that they are among the intended beneficiaries of the association's activities), (4) trustees in bankruptcy, or (5) other persons or groups that could be characterized as direct beneficiaries of the association's activities (such as certificate holders).

1. Basis of Suits. Derivative lawsuits against individual board members of a nonprofit association allege violations of one or more of the fiduciary duties resulting in actual damages to the association. In *The Case of the Bullish Board*, the Board members could be held personally liable for the loss suffered by the association as a result of their actions. In *The Concrete Example of Divided Loyalty*, the interested board members who voted in favor of an announcement that was financially beneficial to them could be forced to disgorge the ill-gotten gains to the association. Similarly, a board member usurping the benefits of promoting a prestigious educational program in *The Case of the Good Idea*, may be forced to forfeit the program and return sponsorship to the association.

2. Waste of Assets. A separate basis for board member liability to the association, which cannot be protected by the Business Judgment Rule regardless of the process used is <u>waste of association assets</u>. Association assets are wasted when funds or assets are given away or applied to improper purposes. Spending money on extravagances that do not further the purposes of the association can amount to waste and render a board personally liable for such excesses. In addition, failure to productively employ the association's assets, or permitting assets to deteriorate, may constitute waste.

Nevertheless, most association-related expenses do further the aims of the association in some manner. Generally, the board will have the benefit of the Business Judgment Rule as to the amount and manner of such expenditures.

3. Lack of Basis of Suits. Derivative suits which merely express disagreement about a policy or action, but do not claim, or cannot prove, a breach of the duties of care, loyalty or fidelity to purpose, or assert waste, will not generally succeed.

B. Third-Party Suits

Board members are ordinarily protected from liability to third parties for the actions of the association through its employees and agents. Generally, such third parties must look to the association (and not its officers and board members) for redress. However, under certain circumstances, individual board members may expose themselves to personal liability.

1. Direct Participation. A board member cannot rely on the association's shield for actions taken by him or at his direction that result in civil or criminal liability. Thus, a board member playing an active role in tortious conduct (e.g., slander or libel against a third party) could be held personally liable for damages. Merely voting for an action that is tortious or illegal can, but usually does not, by itself, constitute a substantial enough role to subject the director to liability. Conversely, a director who votes against an action (on the losing side) that turns out to be tortious or illegal will not be held personally liable for the action. (Hence, it is important to record the votes of dissenting members.)

Although the possibility of board member liability in third-party suits seems remote, it must be stressed that the mere allegation of liability by a third party must be responded to, and the cost of responding will fall upon the individual director, unless otherwise excluded or insured against.

Any organization which has the authority to (1) censure, or otherwise expose individuals to public disgrace or embarrassment, or (2) license or endorse a person or entity (or refuse to do so) in a way which will benefit (or damage) the person (or entity), risks committing tortious acts; and to the extent that a director is personally involved in the process, he or she may be required to respond to civil lawsuits.

2. Statutory Violations. Board members of associations (for-profit or nonprofit) cannot escape liability for activities of the association which are a violation of civil or criminal statutes if they are participants in, or responsible for, the violation. For example, denial of association membership on the basis of race, in violation of the Civil Rights Act, may result in personal liability for any director participating in (e.g., voting for) the denial of membership.

IV. PROTECTIONS AND SAFEGUARDS

In the interest of encouraging qualified individuals to serve on the boards of nonprofit associations, the law has developed a variety of devices to help insulate board members from most kinds of liability.

A. Indemnification by the Corporation

1. Statutory Protection

a. Indemnification in the Articles. A board member's standard of care and applicable limits on liability are generally governed by the corporate code of the state of incorporation. State codes authorize associations to indemnify their officers and board members against costs and damages from lawsuits arising from their actions taken in the scope of their duties, provided that their conduct was not willful or reckless. The statutes generally require a finding by the board that the individual board member or officer satisfied enumerated standards of conduct. Associations frequently incorporate the statutory indemnification powers in their articles of incorporation or bylaws. ASHA has such a provision.

b. Limitation on Personal Liability for Association Matters

Recently, a number of states, including Kansas, have permitted an association to include a provision in its articles of incorporation which expressly eliminates or limits a board member's personal liability to the association for a mere negligent breach of the duty of care. This protection does not include: (1) a breach of the duty of loyalty, (2) acts or omissions which are not in good faith or which involve knowing misconduct, or (3) any transaction in which the director derives improper personal benefit. ASHA has not adopted such a provision.

c. Volunteers' Immunity. Recent federal legislation, the Volunteers Protection Act of 1997, has provided nonprofit association volunteers with immunity under most circumstances. Kansas, Maryland and several other states have also adopted statutory provisions granting limited "immunity" from personal liability for uncompensated or voluntary directors, or officers of nonprofit organizations for negligent acts or omissions. However, immunity may depend on the law of the state where the lawsuit is brought, or possibly where the alleged act occurred. This immunity will <u>not</u> apply if the person engages in, or authorizes others to engage in, actions that are willful or wanton, or are intentionally tortious.

2. By Contract. Most states, including Kansas, recognize a corporation's authority to provide indemnification beyond that specifically authorized by statute. This is often accomplished by contract. The advantage of a contract, in addition to the increased scope of coverage, is that the scope of coverage cannot be decreased or altered by a change in law, articles of incorporation or bylaws. As with any act for the benefit of officers or directors, an extension of the statute must be fair to the association.

B. Director & Officer ("D&O") Insurance

D&O insurance is a "safety net" beneath the association's obligation to provide indemnification. D&O insurance is most valuable when the association lacks sufficient resources to cover costs and/or damages. D&O insurance is particularly attractive to nonprofit associations due to their limited financial means.

A typical D&O insurance policy includes two-part coverage. First, it reimburses the association for payments made to, or on behalf of, a board member or officer for expenses and/or damages arising from a covered lawsuit. Second, it provides direct payments to board members or officers (possibly including advances for payment of legal fees) for expenses or damages. A D&O policy does not insure the association against claims lodged against the association itself. Such claims are covered by the association's comprehensive general liability policy.

ASHA's D&O insurance policy includes the following typical limitations:

(i) Coverage will apply only to persons with titles specified in the policy (specifically, "Director, Officers or Staff, including Executives, Board Members, Committee Members and Employees"), and may not cover persons without such titles.

(ii) Persons will be covered only to the extent that they are acting within the scope of their duties.

(iii) The D&O policy will only cover individuals working for entities named in the policy (ASHA, the ASHA PAC, the National Student Speech-Language-Hearing Association, the National Association for Hearing and Speech Action, and ASHA Foundation).

(iv) Under certain circumstances, the insurer may decline to advance expenses prior to resolution; leaving the association or the individual with the burden of legal fees.

(v) ASHA's policy will only cover acts of negligence and will not cover directors found to have engaged in willful misconduct.

(vi) ASHA's policy will not cover lawsuits brought by, or on behalf of, the association, or brought by another officer or director.

Serving on the board of a nonprofit association carries with it significant legal responsibility. Common sense can take you very far in conducting your activities properly. Requesting advice from experts, lawyers and consultants can protect you. Take your time and be conscientious. Care, loyalty and fidelity in all your board actions is your best protection.