

THE AMERICAN SPEECH-LANGUAGE-HEARING ASSOCIATION:

LEGAL RESPONSIBILITIES OF MEMBERS OF THE BOARDS OF NONPROFIT ASSOCIATIONS¹

I. OVERVIEW

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

A Board member acts as a part of a Board, and directs – but does not perform – the association’s duties. The Board member acts on behalf of one or more constituencies. Individuals who serve on the Board of an association, however, 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?

¹ Prepared by ASHA Legal Counsel Neil Levy
Posted 10/2013

II. BOARD MEMBERS' DUTIES TO THE ASSOCIATION

A. Overview.

Board members must know the purpose and/or mission of the association, the articles of incorporation, the bylaws, and the persons or interests the association serves. Board members are responsible for defining, modifying or clarifying the purpose or mission of the association, after any necessary consultation with the association's members. Board members must manage the association in a manner consistent with such purpose or mission, including establishing and overseeing the implementation of the association's major policies and procedures, ensuring the senior management is managing in a consistent manner with such purpose and/or mission and holding senior management accountable for compliance with U.S. laws and corporate articles of incorporation and bylaws. Board members are responsible for overseeing the management of the association's finances, including reviewing and approving budgets, financial projections, financial controls, compensation for senior management of the association and reports on audits of the association's finances and other activities.

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 by Board members in good faith with the same degree of care exercised by a reasonable, prudent person in the same position and in a manner reasonably believed to be in the best interest of the association.

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 they properly reach the decision. 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. The Business Judgment Rule does not apply in cases of criminal activity, fraud or willful misconduct.

Recent failures in corporate responsibility have led to an ABA Report on the Task Force on Corporate Responsibility. It reads, at page 9:

It has always been recognized, however, that executive officers and other employees of public companies may succumb to the temptation to serve personal interests in maximizing their own wealth or control at the expense of long-term corporate well-being. To check such temptation, and to focus the corporation on the interests of the shareholders, our system of corporate governance has long relied upon the active oversight and advice of independent participants in the corporate governance process, such as the outside directors, outside auditors and outside counsel. Corporate responsibility and sound corporate governance thus depend upon the active and informed participation of independent directors and

advisers who act vigorously in the best interests of the corporation and are empowered effectively to exercise their responsibilities.

B. 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. A Board member must take steps to be informed, and then, as defined by The Revised Model Business Corporation Act, the duty of care is 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 manner 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.

2. Stock Investment Example. In January of 1999, the Board of a nonprofit 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 in the telecommunications area. The Board discusses the committee’s recommendation and decides to purchase stock in 1999 in WorldCom at the high value of \$63.50. The Association has lost its investment, and the members of the Board are sued for entering into a patently unfavorable investment.

The Board is likely to be shielded by the Business Judgment Rule. Their decision, although clearly wrong in hindsight, 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 Board would have failed in its duty of care and would not have been protected if they had failed to make the investment decision “on an informed basis.” Thus, seeking competent advice and considering a range of options was critical to qualifying for protection under the Business Judgment Rule.

3. Executive Compensation Example. The Board of the United Way of America paid the President of the nonprofit a \$500,000 salary and benefits. The President also used the nonprofit's funds to pay for luxury vacations, apartments and gambling trips. Ultimately, the President was convicted on felony counts of looting the nonprofit to subsidize his lifestyle and sentenced to jail time.

Previously, the only action the IRS could take would be to revoke the tax-exempt status of the charitable organization. As this was impractical, Congress enacted a new law that allows the IRS to fine nonprofit executives of charities who receive excessive salaries and benefits, as well as the nonprofit Board members of such charities who approve the arrangements. (See discussion below of Intermediate Sanctions of the Internal Revenue Code.)

Setting compensation for top executives of nonprofits is one of the most important functions of the Board. Executive compensation should be related to performance measured by stated goals and based on comparisons of similar executives in other nonprofits.

4. 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:

a. Attend meetings. Board members should know how Board meetings are scheduled, conducted and documented. Not only should the Board member attend the Board meetings, the Board member should regularly attend any committee meetings on committees which the Board member serves. Electronic mechanisms may be used so that Board members may participate electronically even if they may not participate through their physical presence. Courts are not sympathetic to Board members who argue as a defense that they were not aware of a particular issue or did not participate in a particular action because of repeated failure to attend meetings. Also, Board members who do not attend meetings are bound by the actions taken at those meetings and will be held responsible if any such actions are deemed negligent.

b. Be informed, monitor the activities of the association and exercise independent judgment. Board members must take the time to become informed and base decisions on their own, independent judgment in the best interests of the association. If a Board member does not feel adequately informed, the Board member must ensure that he or she has an adequate flow of information and should ask for clarification if necessary. Board members should independently evaluate the position taken by any other Board member, the association's senior management and staff, or any outside expert. Board members may inspect for reasonable purposes and at reasonable intervals the association's books and records and may request that financial data be compiled regularly for presentation to the Board. Board members should be inquisitive and regularly obtain reports and other information that might help detect mismanagement, illegality or other improprieties. Board members should ensure, through national office staff, that the association complies with the law, including health and safety standards, mandatory insurance coverage and the tax laws. Board members should be objective and independent. Remember that a Board member's duty is to the nonprofit and not to any person or constituency.

c. *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. Board members may rely upon the reports, communications and information received from an agent if the Board member reasonably believes the agent and the information and recommendation to be reliable and competent. Remember, though, that the Board member must still make an independent judgment and not just rubber stamp the advice provided.

d. *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. Board members may rely upon the reports, communications and information received from a committee or from any officer or employee, if the Board member reasonably believes the source to be reliable and competent. Of course, such reliance must be reasonable, and directors must still exercise independent judgment in assessing recommendations of management.

e. *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, and the Board is not required to, and should not perform the work done by the committee, if the committee's recommendation is reasonable and competent.

f. *Delegation, not abdication.* Adopt appropriate policies and procedures to establish effective oversight of the association and compliance with all applicable laws. Do not conduct the day-to-day operations of the association; instead, oversee such operations. Consider reviewing the scope of authority delegated to senior management to clarify lines of responsibility.

g. *Create a record of the decision-making process demonstrating reasoned decisions.* 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, demonstrating that the Board made reasoned decisions.

h. *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. If a Board member disagrees with an action proposed at a meeting, the Board member should state his disagreement and vote against the action or have the Board member's dissent entered in the minutes of the meeting. If a Board member becomes aware of illegal activity, the Board member must bring it to the attention of the appropriate executive or the full Board. If the illegal activity is not corrected, the Board member should carefully consider his or her next steps and obligations to the corporation. Also, the Board member may have legal obligations to disclose the matter to select government, ethics and licensing authorities.

C. 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.

With respect to self-dealing transactions, if the association enters into a transaction in which a Board member has an interest, then the interests of the association must come first. 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), who 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. Generally such self-dealing transactions are not prohibited so long as the Board member discloses his interest so that the other disinterested Board members may objectively evaluate the transaction. In fact, it is very common in the association world for there to be conflicts of interest, and it is often desirable for the association to enter into transactions with interested parties. The greatest obligation, which also provides protection from liability, is for Board members to fully disclose all potential conflicts of interest so that disinterested Board members may perform due diligence to decide whether to pursue an opportunity and to ensure that the association is getting a fair and necessary deal.

With respect to corporate opportunities, if a Board member becomes aware of a business transaction or other opportunity offered by another party that the Board member believes would be of interest to the association, the Board member or a related person or entity cannot take advantage or "usurp" the opportunity. Whether a breach actually occurs will depend on a number of factors, including the relationship between the opportunity and the association's principal activities. Again, the safest route for a Board member is to first offer the opportunity to the association and disclose the Board member's interest in the opportunity. The disinterested Board members may then objectively evaluate whether or not the association is interested in the opportunity. If the association rejects the opportunity, then the Board member may take advantage of the opportunity.

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. Board members must not use confidential information for their own benefit. Only if the Board approves such use of confidential information may the Board member take advantage of information belonging to the nonprofit association.

2. Examples of Self-Dealing.

a. Example of Board Member Serving on Additional Boards. Board member is serving on the Board on Nonprofit Association #1. Board member is also offered to serve on a Board for a related Nonprofit Association # 2. In addition, Board member is offered an opportunity to join an advisory Board for a Publication Corporation which sells publications in the same field as is served by the Nonprofit Association #1. May Board member serve on all Boards? Generally, yes, simply joining a Board does not necessarily place the Board member in a conflicted

position. The Board member must have the time to meet the duty of due care to all associations or corporations if he or she agrees to serve. Also, the Board member is now in a situation where he or she must be particularly sensitive to conflicts and recognize when a conflict exists.

Once becoming aware that the Association Nonprofit #1's interests may conflict with the Board member's or the Publication Corporation's or Association Nonprofit #2's interests, then the Board member must disclose the conflict – in this situation it is possible that the conflict must be disclosed to both Boards. The Board member must comply with this duty to disclose even if the Association Nonprofit #1 would be engaging in a transaction on fair terms, the information is not considered valuable or the opportunity is not one the nonprofit would want. Conflicts may exist for a Board member even if he or she receives no direct monetary or other tangible benefit from a transaction with the association. Conflicts may also be issue related. For example, if a director fails to disclose that he or she has a personal interest in an issue that is adopted by the association and that interest is later publicly disclosed, the association may be harmed.

Once a conflict has been identified and disclosed, the Board member should not vote or use any influence in the matter. The disinterested members of the Board will actually determine whether or not there really is a conflict. To bolster the appearance of disinterested discussion and approval or disapproval by the disinterested members of the Board, the Board member should leave the meeting for the duration of time in which the matter is discussed.

If the Board decides to go forward with the transaction, the transaction must be approved by a disinterested majority of the Board only after (i) full disclosure by the affected Board member of the material facts regarding the Board member's interest in the transaction; (ii) due diligence into the transaction; and (iii) taking steps to ensure that the transaction is fair to the association at the time the transaction is approved.

b. *Example of Board Member Individually Benefiting from Board Decision.* 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. A long-standing member of the Board who is an advocate for the benefits of cement foundations owns 40% of the stock of a large, multi-state cement distribution company. The public endorsement will clearly increase the cement company's revenues. Can he vote for the announcement? If so, how can he protect himself from allegations that he engaged in self-dealing?

The permissible level of participation by "interested" Board members depends upon the circumstances. For example, if the nonprofit were to endorse a method provided exclusively by the Board member's cement company 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. If the nonprofit were to issue a general criticism of cinder block or wood foundation materials, the interested Board member may choose to take the minimal precaution of disclosing to the Board his or her interest, and otherwise participate in the decision.

c. *Example of Stock Investment.* With respect to the stock investment in WorldCom discussed previously, if the Board member recommending the investment had a financial interest in WorldCom, the Board member's actions would be subject to scrutiny as a breach of the duty of loyalty. Also, if the Board member recommended a particular investment firm to the association and the Board member's employer had a relationship with the investment firm and received commissions from the investment firm, and the Board member failed to disclose the conflict, then the Board member's actions would again be considered in breach of the duty of loyalty. In both circumstances, 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. Please note that such self-dealing does not necessarily subject the Board member to personal liability if it turns out that the association got a fair deal.

d. *Example of Startup.* An association became majority stockholder in a biotechnology startup company, and several members of the Board of the association were also given stock in the startup company. The startup company began to have cash flow problems and suffered a significant drop in stock price. The Board voted to maintain the association's investment in the startup company, and the startup company failed with the association losing its entire investment. What should the Board members who were stockholders have done?

3. Examples of Usurping Corporate Opportunities.

a. *Example of Land Opportunity.* A Board member of a nonprofit association is a developer and has been seeking land for development purposes. The Board member is also aware that the nonprofit association has been seeking to purchase land adjacent to its current facility so that a new building may be built that connects underground to the original building. The Board member informed the Board that he would keep his ear to the ground regarding opportunities to purchase such land for the association. The Board member becomes aware that the land adjacent to the current facility is for sale, and the Board member purchases the land for his development company without disclosing the offer to the Board. Has the Board member done anything wrong? Where does the Board member's loyalty lie? Should the Board member have done something differently? Has the Board member usurped a corporate opportunity? Board member has usurped a corporate opportunity and should have disclosed the offer to the Board. If the association desires the land, it may be able to treat the land as having been purchased by the Board member for the association.

b. *Example of Program Sponsorship.* A Board member of a nonprofit association is also the head of a prestigious hospital. An Ad Hoc Committee of the association recommends that an interdisciplinary symposium on gene research be sponsored by the association in a few months. The Board member believes that his hospital would want to sponsor such a program and discusses the idea with the hospital. The hospital eventually announces it is sponsoring the program before the association decides whether it wants to sponsor the program. The Board member has violated his duty of loyalty to the nonprofit by usurping the nonprofit's opportunity to sponsor the program.

4. Examples of Breaching Confidential Information Obligations.

a. *Disclosure of Journal Title.* A nonprofit association, dedicated to medical news, is about to start a new journal directed toward teens entitled “Teen Health.” The nonprofit association wants to trademark the journal name. A Board member of the nonprofit association tells his friend, who is employed by a publisher of teen magazines, about the new journal, and the publisher then proceeds to publish a new journal entitled “Teen Health.” The Board member has breached his duty of loyalty to the nonprofit association.

b. *Purchase of Stock.* A nonprofit association solicited bids for building a new research and development facility and auditorium. Once the final bid was selected, a Board member of the association purchased stock in the winning bidder. Is this a breach of the duty of loyalty? Yes. Use of confidential information to buy stock is not only a breach of the Board member’s duty to the nonprofit association, it may also be considered insider trading by the Securities and Exchange Commission.

5. Steps to Help Satisfy the Standard of Loyalty.

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

b. Board members should consider articulating and disclosing any possible conflicting interest – or even an appearance of a conflict – both on a general level and as specific conflicts arise.

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

d. The remaining disinterested Board members will decide whether or not there is a conflict of interest.

e. If there is a conflict of interest, the Board must investigate alternatives to the proposed transaction or arrangement. After exercising due diligence, the Board must reasonably believe that the transaction in question would be fair to the association, that the price paid or the cost to the association is consistent with the market for the products and services purchased, that the Board would approve the transaction had the other party not been an insider and that the association could not obtain a more advantageous transaction or arrangement with reasonable efforts from a person or entity that would not give rise to a conflict of interest. The Board must also demonstrate the need for the products and services and the ability to finance the transaction as well as discuss the negative impact to the association.

f. A majority of disinterested Board members must approve transactions where there are interested Board members.

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

h. If a Board member has reasonable cause to believe that another Board member has failed to disclose such conflicts of interest, the Board member must promptly inform the other Board member and provide an opportunity for the other Board member to explain the reason for failure to disclose. If the Board determines after hearing the explanation and conducting due diligence that the Board member failed to disclose an actual or possible conflict of interest, then the Board must take disciplinary action.

6. 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:

a. 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?

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

c. 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.

D. Duty of Fidelity to Purpose.

1. The Standard. The Board of a nonprofit association must follow the association’s purposes and goals as set out in the association’s articles, bylaws, purpose and mission statements. Also, the Board of a nonprofit association must comply with particular instructions which may come from the terms of gifts or bequests. A Board member’s duty of fidelity to purpose, which is 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 to retain the privileges of a nonprofit association.

2. Examples.

a. *Misuse of Certification Process.* The Board of a nonprofit 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, and who subscribe to the X School of Thought. Because the members of the Board feel that there are too many advice givers in Region Y and they do not approve of the Y School of Thought, they rarely approve applications from new Region Y advice givers seeking certification or from any other region if the applicants subscribe to the Y School of Thought. In effect, the Board of the nonprofit association has become a tool for (1) eliminating competition for its members and increasing their economic benefits, to the clear detriment of candidates for certification; and (2) requiring all those certified to subscribe to the X School of Thought. In both circumstances, the members of the Board of the nonprofit association have breached the duty of fidelity to purpose by abandoning the impartial consideration of applicants seeking certification intended by the nonprofit's founders.

b. *Allegiance to Constituency.* Board member is selected by the nonprofit association to be a liaison to a group of doctors providing medical services to those who are hearing impaired. Does the Board member have a duty of obedience to represent this particular constituency? No, the Board member may bring this constituency's issues and perspectives to the Board's attention, but the Board member's duty is to advance the overall mission and interests of the nonprofit association.

c. *Bequest for Particular Purpose.* A wealthy individual bequeathed \$10 million in stock to a trust for a scholarship program for doctoral candidates in speech-language or hearing to be administered by the association. A Board member wants to fund another project with this money. To do so would be a breach of the duty of fidelity.

3. Steps To Help Satisfy The Standard.

a. Board members should review the dedicated purposes of the association, including purposes identified in the articles of incorporation, bylaws, mission statements and other documents of the association.

b. 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.

c. Board members should annually review activities for conformity with the association's self-espoused objectives.

d. Board members should ensure that bequests for particular purposes are used for the purpose specified.

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

ASHA is a nonprofit corporation which is a separate recognized legal entity, separate from the individuals who carry out its operations. Consequently, ASHA has all of the benefits of operating as a corporation under state law. Thus, in most situations, the nonprofit association's Board members are insulated from liability for the association's contracts or the negligence of its employees or agents. 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.

Association directors are most commonly sued for the following: wrongful discharge, defamation (employees, membership and Board disputes, suppliers, enemies or opponents), ERISA, investment of association funds, general mismanagement resulting in consistent and significant losses, violating bylaws and articles, unfair dealing with members, antitrust issues, insider transactions (but Board members may be protected if they follow procedures discussed above), corporate opportunity, waste of corporate assets (most commonly sale of assets below value), breach of contract (but as discussed above, Board members are generally not personally liable for breach of a contract by the association), failure to protect association property, vicarious liability (especially when there is a failure to supervise the work of corporate officials), and tort liability (for torts in which Board members actually participate).

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. If the Board members had breached their duty of care when making the stock investment in WorldCom, the Board members could be held personally liable for the loss suffered by the association as a result of their actions. If an interested Board member voted in favor of an announcement that was financially beneficial to them, the Board member could be forced to disgorge the ill-gotten gains to the nonprofit. Similarly, a Board member usurping the benefits of

promoting a prestigious educational program by giving the idea to his hospital 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 waste of association assets. 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.

4. Example. In Connecticut, state hospitals had assumed they were immune from suit and had devoted funds from "free bed trust funds" to purposes different from those intended by the donors. The state attorney general brought suit and asked for an accounting. The hospitals were ultimately required to restore the money to an endowment for free care and publicize the availability to needy patients.

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 Board member to liability. Conversely, a Board member 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 Board member, 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 Board member 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 Board member participating in (*e.g.*, voting for) the denial of membership.

IV. PROTECTION 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.* Federal legislation, the Volunteers Protection Act of 1997, has provided nonprofit association volunteers, including Board members, 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 not apply if the person engages in, or authorizes others to engage in, actions that are willful or wanton, grossly negligent or are intentionally tortious. The Act does not cover actions that affect compensated nonprofit officers and excludes from protection the actions that affect nonprofit officers and directors most frequently, such as claims relating to wrongful termination and discrimination.

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.

C. Conclusion. 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.

V. INTERMEDIATE SANCTIONS OF THE INTERNAL REVENUE CODE

Prior to the enactment of Section 4958 of the Internal Revenue Code which provides for "Intermediate Sanctions," if the IRS believed a tax-exempt organization had entered into a transaction in which a private person would be financially benefited to the detriment of the nonprofit, the only penalty was revocation of the corporation's tax-exempt status. The IRS, therefore, had to choose between an organizational "death penalty" or no penalty. These two extremes caused Congress to enact the "intermediate sanctions" termed "intermediate" because the penalties fall in between the two former extremes of revocation of tax-exempt status and no punishment. The intermediate sanctions are excise taxes imposed on "excess benefit" transactions, which refers to improper benefits derived by private persons from public charities.

To be considered tax-exempt under I.R.C. § 501(c)(3) or (4), no part of the net earnings of the nonprofit may inure to the benefit of any private individual. This rule has been termed the "private inurement" prohibition, and the excess benefit rule is designed to prevent anyone from diverting a charity's income or assets to personal use. Rather than sanction the charity, the intermediate sanctions penalize the private person who receives the excess benefit. The statute is aimed at penalizing "disqualified persons" –the organization's key officers (CEO, President, COO, CFO, Treasurer) and directors, and others who are in a position to influence or control the organization's business affairs including potentially significant donors. An excess benefit transaction is any transaction in which an economic benefit is provided by a tax-exempt organization to any disqualified person and the value of the economic benefit exceeds the value of the consideration (including the performance of services) received by the organization.

Because the penalties can range up to 200% of the "Excess Benefit" involved, these sanctions are the most extreme excise taxes in the Internal Revenue Code. Examples of excess benefit transactions include with respect to "disqualified persons:" (i) the transfer of property for less than fair market value, (ii) the payment of unreasonable compensation, or (iii) the use of the nonprofit's assets or facilities without adequate compensation to the nonprofit. IRS agents looking to raise revenue only need to allege that a transaction or compensation constitutes an excess benefit. The burden then shifts to the individual taxpayer and Board member to prove that it is not. Fortunately there is a safe harbor method of approving transactions with "disqualified persons" that shifts that burden of proof back to the government.

A. Two-Tier Disqualified Person Tax. A disqualified person that benefits from the excess benefit transaction is subject to a first-tier penalty tax equal to 25% of the "excess benefit." A second-tier tax is also imposed if the prohibited transaction is not corrected. The second-tier tax is equal to 200% percent of the excess benefit involved.

B. Tax on Directors and Officers who Approved the “Excess Benefit” Transaction. Any director or officer of a nonprofit who knowingly participates in any excess benefit transaction is subject to a tax equal to 10% [with a cap at \$10,000] of excess benefit unless such participation is not willful and is due to reasonable cause.

C. Rebuttable Presumption.

1. Under the IRS Regulations, a compensation arrangement between a tax-exempt organization and a disqualified person (such as a director, CEO, COO, CFO or Treasurer) is presumed to be reasonable (*i.e.*, rebuttable presumption) and the transfer of property is presumed to be at fair market value (and therefore no excess benefit) if the following conditions are satisfied:

a. The compensation arrangement or the terms of the property transfer or other transaction with the charity are approved by the Board or the appropriate committee (the “Authorized Body”) of the tax-exempt organization composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transaction;

b. The Authorized Body obtained and relied upon appropriate data as to comparability before making its determination; and

c. The Authorized Body must have adequately documented the basis for its determination concurrently with making that determination.

2. The IRS can rebut this presumption, if for example, the IRS establishes that the salaries used as comparables were not for functionally similar positions.

3. The Authorized Body must adequately document the basis for its determination concurrently with making that determination.

VI. IMPACT OF SARBANES-OXLEY ACT ON NONPROFIT ASSOCIATIONS

The American Competitiveness and Corporate Accountability Act of 2002 (“Sarbanes-Oxley”) was signed into law on July 30, 2002. Almost all of the provisions of the bill apply only to publicly traded corporations; however, some state attorneys general have proposed that certain aspects of Sarbanes-Oxley should apply to nonprofit associations. Many nonprofit associations are examining whether or not to voluntarily comply with Sarbanes-Oxley. Senator Grassley, R-Iowa, Chairman of the Senate Finance Committee, in reaction to a scandal at the Nature Conservancy, is considering making portions of Sarbanes/Oxley applicable to non-profits. The proposed legislation includes:

1. IRS review of tax status every five years;
2. federal liability for non-profit board members who neglect their duties; and

3. requiring the chief executive to certify to the accuracy of annual tax filings.

Also, in November of 2004, California adopted the first governance law for non-profits doing business in California, requiring any non-profit with revenues over \$2 million to form an audit committee and compensation committee.

A. Independent Audit Committee. Sarbanes-Oxley requires that any member of a company's audit committee be a member of the Board and independent such that they are not part of the management team and do not receive any compensation either directly or indirectly from the company for professional services other than payment for serving on the Board. Companies must disclose whether they have a financial expert on the committee and, if not, explain why not. Consequently, nonprofits should consider establishing a separate audit committee or subcommittee composed of Board members, which is separate from the finance committee, especially if the nonprofit conducts outside audits. The non-profit should ensure that the Board members serving on the audit committee are independent and financially competent. The audit committee should have at least one financial expert and all Board members should receive financial literacy training as needed.

B. Auditors. Sarbanes-Oxley requires the lead and reviewing partner of the auditing firm to change every 5 years, and prohibits the auditing firm from providing non-audit services, except for certain pre-approved services or non-material services. The auditing firm must report to the audit committee all critical accounting policies and practices. Thus, nonprofits should consider rotating auditors (individuals or firms) every 5 years, preventing their auditors from providing non-audit services, and requiring their auditors to inform them of any material policies and practices guiding the audit.

C. Certified Financial Statements. CEOs and CFOs of public companies must now certify that their company's financial statements are appropriate and fairly present the financial condition and operations of the company. Also, the CEO, CFO, controller and chief accounting officer must not have worked for the auditors within one year of working for the company. Boards of nonprofits may consider requiring CEOs, CFOs or those with comparable titles to certify the nonprofit's financial statements. Board members of a nonprofit should also ensure that the nonprofit's IRS filings, in particular Form 990 or 990-F, be accurate.

D. Insider Transactions and Conflicts of Interest. Sarbanes-Oxley prohibits a company from making loans to any directors or executives of companies. Many states already prohibit such transactions. Consequently, nonprofits should consider banning such loans or, if such loans are granted, there should be formal due diligence, approval and recordkeeping by the Board with an appropriate review of conflicts of interest.

E. Disclosures. Sarbanes-Oxley requires public companies to make numerous public disclosures, often in areas which do not apply to nonprofits. Nonprofits should carefully consider what information should be made available in addition to the information already provided in Form 990 or 990-PF and to whom such information regarding the nonprofit's financial condition should be provided.

F. Whistle-Blowers. Sarbanes-Oxley provides whistle-blowers with new protections. It is illegal for any corporate entity, including nonprofits, to punish whistle-blowers. Consequently, nonprofits should take steps to ensure that their accounting practices are sound and not vulnerable to fraud and abuse, including establishing and enforcing written policies regarding misconduct and employee complaints. Nonprofits should also take steps to prevent retaliation against any whistle-blowers.

G. Document Destruction. Sarbanes-Oxley criminalizes the alteration, falsification or destruction of any document to prevent its use in an official proceeding. Consequently, nonprofits should establish and enforce policies and procedures regarding retention and destruction of documents, including those in electronic form.