THE RESPONSIBILITIES OF SERVICE:

A Guide for Directors of Nonprofit Organizations in Michigan

CLARK HILL

FOREWORD

Michigan is blessed with a wealth of nonprofit and philanthropic organizations – each seeking to improve the quality of life, health, or well-being of individual citizens, families, or specific groups. This abundance of nonprofits enriches our civic life and provides many opportunities for community service. Among these service opportunities, none is more crucial to a nonprofit's success than the role of trustee or director serving on the governing board.

Community leaders selected to serve as nonprofit board members assume special responsibilities – both to the organizations they serve and the public they represent. Nonprofit trustees or directors are charged with furthering the organization's mission and, in the process, improving civic life. They shape both organizations and communities as they fulfill the duties of board membership. As such, the responsibilities of this type of service deserve serious consideration.

To assist civic leaders in understanding the scope and depth of board service, Clark Hill has prepared the following guide. If you are considering board service for the first time, this publication will help to introduce your new role and its duties. If you are a seasoned director, the content of this document may serve as a useful review. In either case, a modest investment of time may offer substantial benefits to you, to your nonprofit, and to the community at large.

Russell G. Mawby
Chairman Emeritus
W.K. Kellogg Foundation

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INTRODUCTION

The form and function of the nonprofit board are often puzzling to a new director. Nonprofit boards, although they perform functions similar to their business counterparts, are distinctly different in a number of significant areas. For example, boards of nonprofit organizations, unlike boards of business corporations, usually consist of a relatively large number of directors who are not compensated for their services. Directors of nonprofit organizations often serve uncontested and for long periods of time compared with directors of business corporations. Additionally, nonprofit boards face the continuing challenge of gathering resources in the form of donations and/or volunteers.

Yet serving on a nonprofit board is more than an honorary appointment. Nonprofit directors have many responsibilities similar to business directors, and failure to satisfy those responsibilities can result in personal liability. For that reason, it is critical that directors of nonprofit organizations understand fully the duties and responsibilities of service.

The role of the director in a Michigan nonprofit corporation is the primary focus of this publication. Under Michigan law, a nonprofit organization may exist either as a corporation created under the Michigan Nonprofit Corporation Act or as an unincorporated association. In addition, private foundations are sometimes organized as trusts under state law. While unincorporated associations are not subject to the statutory requirements of the Nonprofit Corporation Act, in general, directors of unincorporated associations are held to similar standards. Directors of unincorporated associations must recognize that their personal assets are subject to greater risk than those of directors of nonprofit corporations, whose liability is limited by the corporate form.

The purpose of this publication is threefold: (1) to explain how nonprofit boards function; (2) to describe the duties, responsibilities, and potential liabilities imposed upon nonprofit directors; and (3) to suggest how a nonprofit organization can shield its directors from personal liability. While this publication is not intended to answer all the questions new nonprofit directors may have concerning their conduct as board members, we are hopeful it will assist readers in identifying liability issues before they become problems and addressing potential problems before they result in liability.

Duane L. Tarnacki
Clark Hill

SECTION I

PURPOSE OF THE BOARD

The overall purpose of the board of directors of a nonprofit organization is not to manage the day-to-day activities of the organization, but to monitor the results of day-to-day managers. Boards assume this responsibility by exercise of two general functions: taking action and gathering feedback. Taken together, these two functions create an ongoing cycle through which the board of directors is able to govern the nonprofit organization effectively. The board takes action through its decisions and the delegation of its duties and responsibilities. The board then receives feedback from the individuals and committees to whom duties and responsibilities have been delegated, as well as from outside experts, attorneys, accountants, and others, who either supply information or assess and analyze issues as requested.

The responsibilities of the board can be separated into three major areas:
- Defining the mission of the organization;
- Planning the budget and other financial aspects of the organization; and
- Selecting and overseeing the organization's staff.

Mission

The extent of the board's work - the cycle of action and feedback within certain parameters - is dictated by the purposes and goals of the organization. Boards should develop and maintain a meaningful statement of the organization's mission to clearly define working parameters. A mission statement serves to focus the board, and the organization as a whole, on long-term objectives. The board is responsible for the initiation, periodic review, and refinement of the mission statement and developing related strategies to accomplish the organization's goals.

Financial Planning

The board of directors is also responsible for financial planning. A principal function of many nonprofit organizations is raising funds. In most business organizations, capital is a resource necessary to create an end product or service. However, for many nonprofits, financial resources are the end product. For example, the objective of the Juvenile Diabetes Foundation (JDF) is to support diabetes research. While the JDF's ultimate desire is that a cure or more effective treatment for the disease be discovered, the

focus of the organization's mission is procuring the financial resources necessary to continue research.

Fundraising not only requires detailed financial planning, but also attention to fiscal integrity. The success of a nonprofit's fundraising strategy is often closely linked to the general public's perception of the organization's credibility and efficiency. Directors of nonprofit organizations must carefully supervise the solicitation of donations and contributions, establish and monitor ongoing financial plans, review and approve annual budgets, and oversee audits. Allegations of excessive administrative costs or misappropriation, even if unfounded, can cripple the fundraising ability of a nonprofit organization.

Staffing

The board of directors is responsible for the staffing of a nonprofit organization. In selecting staff leadership, the board must seek individuals who are able to execute approved policies and maintain the organization's integrity. The board also must ensure that the administrative staff is capable of providing board members with the information necessary to monitor the organization's activities. Although staff is responsible for implementing the board's strategic plans through day-to-day operations, the board has a duty to supervise staff functioning. Ultimately, the board will be held accountable for the staff's ability or inability to perform its functions.

Section 2

BOARD OPERATION

Boards of nonprofit corporations are usually much larger than those of business corporations and directors may come from a wider geographic area than their business counterparts. At the same time, directors of nonprofit corporations are often volunteers who are very busy people in their own right. For these reasons, it is often impractical for a nonprofit board to meet often enough to make all operating decisions. Although ultimate responsibility for the operation of a nonprofit corporation falls upon its board of directors, Michigan law does allow the board to delegate authority to committees and officers.

Governance Structure

There are essentially two governance structures available to Michigan nonprofit corporations: directorship and membership. The articles of incorporation must specify whether the corporation is organized on a membership or directorship basis.

In a directorship corporation, there is a single governing body, such as a board of directors or trustees, that is usually self-perpetuating. Although the articles of incorporation will indicate whether members of the governing board are called "directors" or "trustees," the distinction is one in name only.

In a membership corporation (whose members may also be called "shareholders"), there are two tiers of governance: the members, whose primary responsibility is to elect the board, and the board itself. In larger nonprofit corporations, contributors often comprise the membership. By making contributors voting members of the corporation, many organizations seek to expand group ownership, trust, and commitment. However, certain actions, such as amending the articles of incorporation or approving a merger or sale of substantial assets of the corporation, can only be taken with membership approval. Waiting for the members' annual meeting, in these instances, may delay needed action. In addition, some organizations have difficulty maintaining an accurate, up-to-date list of all members.

Most nonprofit corporations find that corporate governance can be streamlined by organizing as a directorship corporation with a single governing body. A directorship corporation may still have members, but they would be non-voting members.

Meetings

A board conducts the business of a nonprofit corporation in one of two ways: through formal action adopted at a board meeting, or by unanimous written consent. Michigan law allows the board of a nonprofit corporation to hold regular or special meetings as needed. Although the law does not specify a minimum number of meetings, boards typically meet quarterly or monthly. A regular schedule of meetings is critical for directors to meet their fiduciary duties as outlined in Section 3. Michigan law provides a further incentive for directors to attend board meetings: In some circumstances, a director is assumed to have consented to action taken by the board during his or her absence. In other words, an individual director may be held accountable for board decisions made while he or she was not present. A director may, however, file a formal dissent to board action after the meeting.

Michigan law does not require that directors attend meetings in person. A member of the board or a committee may participate in meetings by means of conference telephone or other means of remote communication so long as all persons participating in the meeting can communicate with each other. Participation in a meeting constitutes presence in person at the meeting, whether the director is physically present or participating remotely. Unlike members, however, directors do not have the option of voting by proxy or otherwise delegating their discretionary authority.

Meetings of directors and board committees may only be held if a quorum is present. Michigan law generally requires that a majority of the directors or committee members then in office be present to constitute a quorum. However, if the board has eight or more members, the bylaws may set a lower quorum requirement, but not less than one-third of the directors then in office. It is worth noting that this lower quorum requirement is not available to board committees, including the executive committee.

When it is impractical for directors to hold a formal meeting, they take action instead by "signing" a written document which contains resolutions or other board action. "Signing" refers to directors' approval of particular action. Directors may "sign" by electronic transmission, such as email, or formally "sign" in their own handwriting. To be effective, the written consent (or a duplicate) must be "signed" and consented to by all of the board members then in office. This is often referred to as taking action by "unanimous written consent."

Officers

Michigan law provides that unless the articles of incorporation or bylaws state otherwise, the board of directors has the responsibility and power to appoint or remove officers. Frequently, the officers of a nonprofit corporation will be chosen from the ranks of the board of directors. Michigan law requires that the officers consist of a president, secretary, and treasurer. If desired, the board may elect a chairperson of the board, one or more vice presidents, and any other officers as outlined in the bylaws or determined by the board to be necessary. On nonprofit boards, it is not uncommon for one individual to hold two offices.

The Michigan Nonprofit Corporation Act also states that officers elected or appointed by the board may be removed by the board with or without cause. However, officers elected by the members of the corporation may be removed only by a vote of the members. In the case of terminating an employee, an employment contract may affect the board's ability to terminate the employee at will. A nonprofit corporation could be held liable to an employee whose termination results in a violation of the terms of his or her employment contract.

The president is generally the chief executive officer and has the responsibility of supervising and controlling the activities and affairs of the nonprofit corporation. The president is further responsible for executing documents authorized by the board of directors. In the president's absence, his or her duties are often delegated to the vice president. The president may be a volunteer board member or may be an employee of the organization.

The chairperson presides over the meetings of directors and members. In the event that a corporation has only a president or chairperson, that individual is generally responsible for the duties of both offices. Nonprofit organizations sometimes give the chief executive officer the title "executive director." This title may indicate that the position is a staff position rather than one with policy-setting authority.

The secretary of a nonprofit corporation is traditionally responsible for compiling meeting minutes, maintaining corporate records, and ensuring that directors receive notice of meetings. The treasurer's responsibilities include oversight of receipts, payables, and other items related to the cash flow of the corporation; facilitation of audits; and supervision of reports concerning the financial standing of the corporation. The traditional day-to-day responsibilities of both the secretary and treasurer are usually conducted by staff members in today's larger nonprofit corporations, as the positions have become increasingly honorary. Nonetheless, the "honorary" officer should take seriously the responsibility of monitoring the performance of the individuals to whom these functions have been delegated.

Committees

While specific tasks of the board are often delegated to corporate officers, committees of the board are instrumental in developing and executing corporate strategy. Although Michigan law allows for the extensive use of committees, there are limits to the board's ability to delegate authority. In Michigan, the board of a nonprofit corporation may not delegate its power to amend the articles of incorporation; adopt an agreement of merger or consolidation; recommend the sale, lease or exchange of substantial property or assets of the corporation; recommend the dissolution of the corporation; amend the bylaws of the corporation; fill vacancies in the board; fix compensation of directors; or cancel stock or terminate membership in the corporation.

There are three major types of committees which may be designated by the board: standing committees, advisory committees, and ad hoc committees.

Standing (or oversight) committees are usually permanent committees.

They may be responsible for such ongoing functions as financial audits, board and officer nominations, investments, staffing, and employee benefits. The executive committee is considered the most important of the standing committees. An executive committee assumes the board's management responsibilities between regularly scheduled meetings of the board.

Advisory committees are, for the most part, unique to nonprofit corporations. An advisory committee may: (1) serve to expand the organization's "inner circle" by involving members of the business community and the public at large in the organization's work, or (2) connect the organization with experts who can assist the board in evaluating and assessing the needs of the community or the specific groups served by the nonprofit corporation.

Ad hoc committees are special, temporary committees designed to perform specific tasks or address limited problems. An ad hoc committee traditionally exists only for the life of its specific assignment. A capital campaign committee would be one example of an ad hoc committee.

Section 3

Individual Director Duties

As individuals, directors of nonprofit corporations have several duties to the corporation. These duties are applicable to directors of both business corporations and nonprofit corporations. The duties of care, of loyalty, and other fiduciary duties generally constitute the scope of individual liability of a director.

Duty of Care

Michigan law provides that a director of a nonprofit corporation must discharge the duties of that position in good faith and with the same degree of diligence, care, and skill which an ordinarily prudent person would exercise under similar circumstances in a like position. This obligation, which is set forth in a state statute, is commonly known as the "duty of care." The duty of care contains a number of elements.

A director must act in good faith. In general, good faith can be defined as honesty of intention, openness, and fair dealing. Since this is a very subjective standard, courts must look for some objective evidence in assessing whether or not good faith was present in a director's actions.

A director must act with the same degree of diligence, care and skill which an ordinarily prudent person would exercise. In this circumstance, "ordinary" does not mean "mediocre." It simply means that the director is not expected to possess any technical expertise or specialization. "Prudence" means that the director is expected to possess and exercise sound practical judgment and common sense, and reach informed conclusions. Prudence, however, does not require excessive caution.

A director must exercise care. The concept of "care" incorporates both diligence and attention. Diligence requires an active interest, such as attending meetings, reading materials, and otherwise making an effort to learn about the corporation and its activities. Diligence is often viewed as an objective standard based on the amount of time dedicated to a task. Attention requires alertness and suggests anticipation of potential problems and issues.

A director's satisfaction of the duty of care is measured in comparison to individuals in similar circumstances in like positions. Comparing the performance of a director to others in a like position allows for flexibility based upon the uniqueness of the specific nonprofit corporation for which the director serves. Circumstances surrounding a decision at the time it was made are also considered. By viewing a decision within the context of similar circumstances, the standard takes into account the specific factors that shape decisions.

The statutory duty of care in Michigan allows for the director's reliance on experts both inside and outside of the nonprofit corporation, including accountants and attorneys. Although reliance on another party does not relieve a director of his or her individual duty of care, it does provide a measure of protection if the experts relied upon have been selected with reasonable care in accordance with the standards set forth above. For example, a director can rely on the financial reports of a reputable accounting firm, but not on reports prepared by an accountant whose competence or integrity is in question.

In business corporations, directors who have satisfied the duty of care are afforded the protection of the "business judgment rule." This rule prevents courts from second-guessing the past business decisions of directors. The business judgment rule is intended to provide total protection from liability for decisions so long as the business decision had a reasonable basis of rationality, involved no conflict of interest, and was a reasonably informed one. The application of this rule in business corporations provides directors with a safe harbor in which to increase economic returns by taking calculated risks.

Directors of nonprofit corporations, however, are not measured by economic or market performance. Although the business judgment rule applies most directly to business corporations, it is easily analogized to nonprofit corporations. The business judgment rule protects directors of nonprofit corporations from liability in order to stimulate creativity and risk-taking as it relates to the accomplishment of the tax-exempt purposes of the corporation. Therefore, to the extent that nonprofit directors take rational actions in good faith, and without conflicts of interest, courts will be reluctant to question those decisions.

Duty of Loyalty

Directors of both business and nonprofit corporations are also subject to the duty of loyalty. The duty of loyalty requires the director's undivided allegiance to the corporation. A director of a nonprofit corporation may possess a substantial amount of power and information with respect to the corporation and its property. The duty of loyalty prevents a director from using such power or information for personal gain.

Duty of loyalty violations often are the result of a subversion of the nonprofit nature of the organization. Directors are required to put the interests of the organization ahead of their personal interests. A director who derives a personal benefit from an opportunity deprives the organization of the benefits of that opportunity. The most basic violations of the duty of loyalty result from conflicts of interest related to the personal financial interests of a director.

Michigan law provides specific guidelines to prevent potential conflicts of interest from resulting in violations of the duty of loyalty. The Michigan Nonprofit Corporation Act states that a contract or transaction between a nonprofit corporation and one of its directors, or between a nonprofit corporation and another corporation in which one or more of the corporation's directors has an interest, is not void (i.e., revoked) or voidable (i.e., revocable at the option of the organization) solely because of the common interest if one of the following conditions is satisfied: (1) the contract or transaction was fair or reasonable when it was authorized, approved or ratified by the nonprofit corporation; (2) the material facts of the director's relationship or interest as to the contract or transaction were disclosed or known to the board and the transaction was approved by the board without counting the vote of the interested director or directors; or (3) the same material facts were known to, and the contract or transaction was approved by, the members of the nonprofit corporation. The Act further states that it is the interested director who has the burden of establishing the validity of such a contract or transaction.

The Michigan Nonprofit Corporation Act allows a nonprofit corporation to lend money to, or guarantee a financial obligation of, a director provided that the loan or guarantee is reasonably expected to benefit the corporation. The loan or guarantee may be with or without interest and may be unsecured or secured in a manner that the board approves. When approving such a transaction for an interested director, however, each non-interested director must be careful not to violate the duty of care. In addition both the interested director and the nonprofit charitable corporation must ensure that the transaction does not give rise to a personal benefit in violation of federal tax laws (i.e., "private inurement").

As previously stated, most duty of loyalty violations will result in conflicts of interest. Conflicts of interest can be avoided by taking a number of precautionary measures:

◆ The first and most important relates to the composition of the governing board. Directors should be financially disinterested from the organization to the greatest possible extent. Small, weak boards which are dominated by one or a few dominant directors are more likely to see conflicts of interest arising from the dominant director's or dominant group's ability to achieve personal gain.

◆ Second, all directors should have a working knowledge of applicable IRS rules in order to recognize situations which may endanger the tax-exempt status of the organization as a result of private benefit or self-dealing.

◆ Third, a formal policy should be established to address potential conflicts as they arise. The policy should include procedures for disclosing the material facts of proposed contracts and transactions with directors while still preserving the privacy of the individual director. The policy should also include procedures for determining whether a contract or transaction is fair and in the best interests of the organization. For example, before a nonprofit organization enters into a major contract for services with a company owned by one of the organization's directors, the board should satisfy itself that a more favorable arrangement is not available on similar terms from a different company.

A conflict of interest policy should be in writing and encompass three key elements: awareness, disclosure, and disinterested review. First, the board must be aware of any personal interests a director or directors may have related to an upcoming transaction prior to the board meeting. To assist directors in recognizing possible conflicts, the organization should require each board member to complete an annual questionnaire disclosing relevant ownership interests and affiliations. Second, the director should disclose any such interest

to the board before it takes action on a related transaction. Third, the interested director should excuse himself or herself from the meeting while the board reviews the matter.

Although conflict of interest policies often exist to protect directors from liability, such policies should not necessarily be limited to the minimum statutory requirements. Conflict of interest and fair dealing policies also benefit the nonprofit corporation by improving relationships between directors and the corporation, fostering trust and defusing tension among individual directors, and creating a favorable public image. Although the Michigan Nonprofit Corporation Act sets minimum standards of conduct, the board should use it as a framework on which to build thoughtful, sound policies to guide the board's actions.

Other Fiduciary Duties

A director of a nonprofit organization has a duty to maintain the confidentiality of the organization. Unless information has been released to the general public, a director should treat the information as private and confidential. A breach of this duty could jeopardize corporate opportunities and foster an environment of mistrust among the directors.

Directors of a nonprofit corporation also have a duty to strictly adhere to the mission of the organization. This duty is not often articulated when discussing the duties of directors of business corporations, since business corporations can use economic results to monitor and assess the performance of directors. Nonprofit organizations, on the other hand, obviously cannot use profitability as a benchmark for performance. Therefore, in a nonprofit organization, it is vital that a director clearly recognize the duty to abide by the mission and purposes of the corporation. The purposes for which the organization was established are described in its articles of incorporation or bylaws. Other documents, such as Internal Revenue Service (IRS) forms, public communications, solicitation materials, and corporate policies - further define the parameters in which the nonprofit corporation is expected to operate.

Although directors are given a great deal of latitude in determining the manner in which the objectives of the nonprofit corporation are to be achieved, a director cannot deviate substantially from or engage in activities which are contrary to the mission of the organization. Where private funds are a substantial source of revenue for the organization, the individuals and organizations who donate those funds do so with the expectation that they will be used to achieve the stated goals. Therefore, private benefactors place a great deal of reliance on the premise that the directors will govern the nonprofit corporation in accordance with its published purposes and goals.

Section 4

LIABILITIES OF DIRECTORS

Generally, the board of directors of a corporation cannot be held liable for the actions of management and staff. The corporate entity is responsible for acts committed by employees, and corporate liability is usually limited to the assets of the corporation. However, in some situations, individual board members may be held personally liable for their actions as directors.

Breach of Duties

The largest source of personal liability for an individual director is a breach of the fiduciary duties discussed in Section 2. It is important to note that these duties are owed only to the corporation and, accordingly, may be enforced only by an individual with an interest in, and acting on behalf of, the corporation - such as another director, or an officer, shareholder, or member. The Michigan Attorney General also is charged with representing the interest of the general public relative to charitable organizations. Thus, an action may be brought by the Attorney General against nonprofit directors on behalf of the public if the Attorney General feels it is necessary to protect the public interest.

Directors who use power or information obtained through their positions for their own benefit are vulnerable to personal liability. This behavior is often referred to as "self-dealing." For example, a director who learns at a board meeting that a parcel of land adjoining the corporation's property will soon be made available for sale and purchases the land for his own account before the organization can act would be liable for self-dealing. By the same token, a director may be held liable for engaging in self-dealing for the benefit of family, friends, or other third parties. For instance, a director who causes the nonprofit organization to deposit large sums of corporate funds in a non-interest-bearing account at a financial institution controlled by his family may be liable for self-dealing.

Liability for Board Actions

Liability may be imposed upon individual directors who vote for or concur in actions taken by the board collectively, if the action is prohibited under state or federal law. For example, the director of a trade association whose board conspires to violate antitrust laws may be held individually liable for the organization's illegal activities or policies.

As mentioned earlier, Michigan law provides that in some situations a

director who was not present at a meeting is presumed to have concurred with board actions unless a written dissent is filed with the secretary of the corporation within a reasonable time after the director learns of the action. Similarly, a director who is present at a board meeting may be presumed to have concurred in certain actions taken at the meeting unless his or her dissent is recorded in the minutes or a written dissent is filed with the secretary of the meeting before or promptly after the meeting. Thus, a director who believes the board is taking action which is illegal or not permitted under law should ensure that his or her opposition is properly documented in the corporate records.

Directors Acting as Officers

In many nonprofit organizations, directors also serve as officers. A director acting as an officer may assume contractual liability if the director enters into an agreement and fails to expressly indicate that he or she is signing as an officer on behalf of the corporation. A director acting as an officer should be certain that his or her actions have been properly authorized or ratified by the corporation. To the extent that actions taken by an officer are not expressly authorized by the corporate bylaws or policies adopted by the board, the action must be approved or ratified by formal board action.

In rare circumstances, officers may be subject to individual liability if their own negligent or intentional participation in wrongful acts or omissions results in injury to a third party. For example, to the extent that an officer assumes responsibility for training or supervising an agent or employee, the officer may be personally liable if his or her failure to provide adequate training results in injury to a third party.

Contractual Liability

Individual liability may also result if a director personally guarantees the repayment of a debt by the nonprofit corporation. Additionally, personal liability may result if a third party relies on the misrepresentations or omissions of a director as an inducement to enter into a contract with the corporation and the third party is damaged as a result of the contractual relationship.

Liability for Staff's Activities

Although a director may not be held personally liable for the negligent acts of employees of a nonprofit corporation, personal liability may result if the negligence of an employee can be attributed to a director's negligent supervision of the corporation. For example, if the directors of a nonprofit day care center hire an executive director who has received numerous citations for failing to satisfy state child care regulations and requirements, the directors may be held personally liable if a child is injured because a safety requirement has not been met. The corporate entity can, of course, be held responsible for the negligent acts of employees performed as part of their duties. It is rare, however, for directors to be held individually liable for the negligence of employees.

Lack of Corporate Identity

Individual director liability may also result if it is determined that the nonprofit corporation does not exist as a separate entity, but merely as an alter ego of a dominant director. In such circumstances, individual liability may be imposed on the dominant director by "piercing the corporate veil." The requirements for piercing the corporate veil are: (1) the corporation does not maintain an existence separate from the dominant director, and (2) fraud or injustice would occur if the corporate veil were not pierced.

Courts consider several factors when determining whether the separate existence of a corporation is legitimate, including:

- Compliance with corporate formalities such as maintaining corporate records and holding regular meetings;
- The separation of corporate and personal assets; and
- The use of corporate assets by the individual as his or her own personal assets.

If a nonprofit corporation has been established for the sole purpose of benefitting and protecting a dominant director, that director will not be allowed to use the corporate structure as a defense to personal liability.

Statutory Liability

Personal liability of directors of nonprofit corporations may also result from violations of state or federal statutes. For example, Michigan law states that any officer or agent of a nonprofit corporation who knowingly falsifies or wrongfully alters books, records, or accounts of the corporation is guilty of a misdemeanor and subject to fines. Tax laws impose personal liability on officers who are responsible for paying withholding and employment taxes on behalf of a corporate employer and fail to do so. Officers and directors may also be held individually liable for gaining personal profit at the expense of a retirement plan under the provisions of the Employee Retirement Income Security Act (ERISA).

In 1996, the Internal Revenue Code was amended to create "intermediate sanctions" designed to penalize officers and board members who receive

overly generous financial benefits through their involvement with a nonprofit organization. The penalties are referred to as intermediate sanctions because they allow the IRS to impose punishment short of revoking the tax-exempt status of the organization. The law applies to Section 501(c)(3) public charity and Section 501(c)(4) social welfare organizations. It gives the IRS a powerful weapon to impose personal liability on individuals who use nonprofit organization assets for personal gain. The law targets abusive compensation arrangements and a broad range of transactions such as purchases, sales, leases, or other transfers of value between an exempt organization and an insider, where the organization does not receive fair value in return.

Under the Internal Revenue Code, many grantmaking institutions are classified as "private foundations" for federal tax purposes. Special rules govern the relationship between directors and officers of a private foundation and the foundation itself. These prohibited transaction rules impose personal liability on directors or officers who engage in acts of self-dealing or violate other restrictions specified in the Internal Revenue Code. Because a technical violation of these rules gives rise to penalty tax liability even if the individual was acting in good faith, it is particularly important that directors and officers of private foundations and their professional advisors be familiar with these rules.

Section 5

PROTECTION FROM LIABILITY

It is important for both nonprofit and business corporations to protect their directors from personal liability. Due to the increasingly litigious nature of our society and the rising costs of litigation, it would be difficult for corporations to attract and to retain competent directors if the directors were expected to individually bear the costs of defending their conduct with respect to the corporation each time it was challenged. This is particularly true for nonprofit directors who often serve without compensation. For this reason, three mechanisms for providing protection to directors have evolved: statutory limitations of liability, indemnification, and insurance.

Statutory Limitation of Liability

In 1987, the Michigan Legislature amended state law to permit nonprofit corporations to protect volunteer directors from personal liability resulting from actions taken within the scope of their role as directors. The law was later amended in 1993, and again in 1996, to extend the protections to volunteer directors from personal liability resulting from actions taken within the scope of their role as directors. Specifically, the Michigan Nonprofit Corporation Act allows a nonprofit corporation to limit the liability of its volunteers in three respects.

First, the Act provides that the nonprofit corporation may limit the liability of volunteer directors and officers to the corporation and its members for monetary damages for a breach of fiduciary duty. This limitation on liability is subject to certain exclusions, including a breach of the duty of loyalty, actions not in good faith or involving intentional misconduct, knowing violations of the law, other unlawful acts relating to loans or the distribution of corporate assets, transactions from which the director or officer derived an improper personal benefit, and actions that amount to gross negligence.

Second, the Act provides that tax-exempt charitable corporations - those described in Section 501(c)(3) of Internal Revenue Code - may assume the liability of volunteer directors to third parties for acts or omissions if the liability was incurred in good faith performance of the director's duties.

Finally, the Act provides that a nonprofit corporation may assume the liability for all acts or omissions of a volunteer director, volunteer officer or other volunteer provided that the volunteer was acting in good faith and within the scope of his or her authority. The volunteer will not, however, be protected if his or her conduct amounted to gross negligence or willful and wanton misconduct or was an intentional wrongful act.

The provisions of the Act permitting limited liability for directors, applies only to "volunteer directors." The term volunteer director is defined as a director who does not receive anything of more than nominal value from the corporation for serving as a director other than reasonable per diem compensation and reimbursement for actual, reasonable and necessary expenses incurred in his or her capacity as a director. Per diem means "per day" and is a reference to the practice of paying directors a specified amount for each meeting attended, as opposed to the policy of paying directors an annual salary or retainer. Thus, directors who receive only per diem fees for attending meetings would be eligible for the statutory protections, while directors who are paid an annual retainer would not.

Nonprofit volunteers should note, however, that the limitation of liability is not automatic. In order to protect volunteer directors or officers or other

volunteers, the Act states that nonprofit corporations must amend their articles of incorporation. In addition, the corporation should be certain that all corporate formalities are observed when the amendment to the articles of incorporation is adopted (i.e., proper notice of meeting given at least 10 days in advance, a quorum is present at the meeting, etc.).

Indemnification

Indemnification is the practice of reimbursing directors and officers for expenses, settlements, and judgments they incur as a result of legal proceedings initiated against them for actions taken in their capacity as directors or officers. The Michigan Nonprofit Corporation Act allows nonprofit corporations to provide indemnification against expenses incurred by a director or officer, if the individual acted in good faith and in a manner he or she reasonably believed to be in the best interests of the corporation.

It is vital that directors and officers understand that the extent of indemnification a corporation can provide without insurance is limited to the value of the assets of the corporation. This is especially important for nonprofit directors, since nonprofit corporations often do not possess significant assets. While Michigan law empowers nonprofit corporations to indemnify their boards and staff, it is the promise of mandatory indemnification that should concern directors and officers. Indemnification provisions typically appear in the bylaws. Therefore, it is important that directors read the bylaws in order to confirm that the corporation has committed in advance to provide indemnification, and to understand the scope of protection that has been afforded them by the corporation.

Insurance

The Michigan Nonprofit Corporation Act authorizes the purchase and maintenance of liability insurance on behalf of directors, officers, volunteers, employees, and agents. These director and officer liability policies - commonly referred to as "D&O policies" - generally have a two-part structure. The first part covers directors and officers individually, by making direct payments to them when they are not protected by the corporation's indemnification. The second part reimburses the corporation for any indemnification payments made to the directors or officers. Many D&O policies for nonprofit organizations will also provide "entity coverage," which broadens the scope of coverage to include the corporation as an insured party for any wrongful act committed by a director, officer, employee, or volunteer.

An organization considering a D&O policy or renewing its coverage should ensure that the policy is tailored to nonprofit organizations. D&O policies that are available to nonprofit corporations often will cover wrongful discharge claims brought by terminated employees. This coverage is not usually available in D&O policies issued to business corporations.

Section 6

SARBANES-OXLEY

In response to governance abuses in the business sector, Congress enacted the Sarbanes-Oxley Act in 2002. While principally directed at publicly traded business corporations, two provisions have broader application and do apply to nonprofits. The first is a whistleblower provision that makes it a federal offense to retaliate against a person who provides law enforcement officers with information relating to the commission or possible commission of a federal offense. As a result of this law, many nonprofits have adopted so-called whistleblower policies to institutionalize the organization's intent to cooperate in any such investigation. These policies must be carefully drafted, however, to avoid creating a private cause of action for retaliation that does not otherwise exist under the law.

The second Sarbanes-Oxley provision that applies to nonprofits is a prohibition against knowingly altering or destroying records or documents with the intent to obstruct a federal investigation or a bankruptcy case. Nonprofits should adopt policies to alert employees, officers and directors of this obligation.

Although not otherwise applicable to nonprofits, Sarbanes-Oxley has been viewed as promoting best practices in the nonprofit sector regarding governance. Some examples of changes adopted by nonprofits: establishing audit committees, revamping audit committee charters to ensure independence and build in other safeguards, and requiring the CEO to sign IRS information returns thereby personally certifying the accuracy of the reports.

Section 7

DIRECTOR'S REVIEW OF FORM 990

Management increasingly asks directors of nonprofit organizations to review the entity's Form 990 – more commonly referred to as the "tax return." This is the result of a governance-related question on the return that asks whether a copy of Form 990 was provided to the organization's governing body before it was filed. Further, it directs all organizations to describe the process the Board uses to review Form 990.

While the IRS does not require a Board of Directors to review Form 990, a director does have a duty to exercise informed oversight of the organization. A review of Form 990 gives a director the opportunity to discuss with management the various aspects of the organization's operations and mission. While a director need not verify the specific data on Form 990, a director should review relevant information disclosed on the return and make further inquires, as necessary.

In reviewing Form 990 and the operations of the organization, a director should consider the following questions, among others:

- **Program Service Accomplishments:** Does Form 990 accurately portray the reason for the organization's existence and what it has accomplished during the preceding year?
- **General Tax Compliance:** Have payroll taxes been timely paid? Has Form 990 been prepared completely and filed on a timely basis? Have any of the activities of the organization resulted in the imposition of penalties or interest? Has the organization received unrelated business income which would require the filing of Form 990-T? Has the organization been involved in political campaigns or lobbying activities?
- **Governance, Management and Disclosure:** Has the organization adopted governance policies and best practices (e.g., conflicts of interest, whistleblower, and document retention and destruction policies)? Has the compensation of directors, officers and key employees been reviewed to determine reasonableness? Are the expenses of the organization justified in light of its activities and income? Have financial statements been prepared and audited? Does the organization disclose to the public the information and documents required by the IRS?

CONCLUSION

Nonprofit board members are not expected to be experts in the area of director conduct and liability. However, by gaining a general understanding of the obligations that accompany a director position, an individual should be able to identify potential problems. Anticipating potential problems and seeking assistance in resolving them will help the individual director avoid a breach of fiduciary duty and possible personal liability claim. With the ability to identify issues before they become problems, board members can direct their attention and energies to serving the organization and fulfilling its mission.

Clark Hill is a full-service law firm of more than 150 lawyers, with a tax-exempt organizations practice that is first among Michigan firms. Our nonprofit clients range from large national institutions to the smallest family foundations and grassroots volunteer organizations. The firm takes special pride in its longstanding tradition of service to charitable, civic and community organizations, and, in that spirit, we are pleased to present this publication to the field.

For additional copies of this publication or more information, please contact:

Clark Hill plc
500 Woodward Avenue, Suite 3500
Detroit, Michigan 48226
Telephone: 313.965.8300
Facsimile: 313.965-8252
E-mail: e-mail@clarkhill.com
www.clarkhill.com

OTHER RESOURCES

Additional information can be obtained from:

Michigan Nonprofit Association
1048 Pierpont Dr., Suite 3
Lansing, MI 48911
Telephone: 517.492.2400
www.mnaonline.org

Board Source
750 9th Street NW, Suite 650
Washington, DC 20001-4590
Telephone: 202.349.2500
Facsimile: 202.349.2599
www.boardsource.org

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