

Fiduciary Duties of Directors and Officers of Distressed Nonprofit Organizations

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The environment in which directors and officers of a financially challenged nonprofit or community-based organization operate has become much more hostile and difficult, even for experienced leaders. Increasingly, courts, regulators, lenders, and other stakeholders have become more aggressive and willing to second guess decisions, heightening the need for the directors and officers of nonprofit and community-based organizations to be diligent in the exercise of their obligations.

This article briefly summarizes the fiduciary duties that the directors and officers of nonprofit and community-based organizations owe to their organizations, the risks of ignoring or violating those duties, and strategies to minimize the risk of director and officer liability.

1. Why Are Fiduciary Duties Important?

Directors and officers of a financially challenged organization may be asked to approve certain transactions, payments, or restructuring strategies. In many cases, such actions (or inactions) may have unintended and unfortunate results for the organization. The directors' and officers' actions—or decision not to act—could be

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attacked (with the benefit of “20/20” hindsight) if the organization was to subsequently falter and stakeholders perceive that they were harmed by the decision to enter into or forego a particular transaction or restructuring.

Decisions regarding a transaction, payment, or other restructuring strategy (whether through action or inaction) could serve as the foundation of breach of fiduciary duty claims or other related claims based upon laws relating to illegal preferences and fraudulent transfers. **Former directors may be held responsible if he or she oversaw the matter being alleged. Although a director relinquishes his or her fiduciary duties upon resignation, a director’s fiduciary duties continue for events set in motion or known about prior to resignation.**

Such claims would be premised in some measure upon allegations that, among other things:

- the organization was (whether through action or inaction) insolvent at the time of the challenged decision, or the organization
- was rendered insolvent by such challenged decision;
- the organization did not receive fair consideration in connection with the challenged decision; or
- the challenged decision preferred certain stakeholders (e.g., insiders) over others or did not maximize the value of the enterprise.

Notwithstanding today’s challenging environment, as a general matter, directors and officers will have fulfilled their fiduciary duties (and thus be insulated from liability) if they act in an informed manner, with requisite care, and in the best interests of the organization.

II. What Are the Legal Responsibilities and Fiduciary Duties of Nonprofit Boards and Their Members?

Directors and officers of nonprofit and community-based organizations are considered fiduciaries, or persons of trust, with the **power** and **obligation** to act with total trust, good faith, and honesty on behalf of their organization.

The leaders of nonprofit and community-based organizations generally have three “fiduciary” duties when acting on behalf of their organization—the duty of care, the duty of loyalty, and the duty of obedience.

Although each of these duties is fairly straightforward to describe, determining whether a director or officer has, in fact, complied with their fiduciary often requires a careful analysis of the facts of a particular situation.

In satisfying its duty of care, a board should inform itself of all material information reasonably available to it, implement a decision-making process that allows members to carefully consider that information and all reasonable alternatives, where appropriate, seek advice from relevant industry, legal or financial advisors, and maintain complete records of board deliberations.

It is important to understand that although nonprofit leaders **may reasonably rely on the advice of outside advisors** in discharging their duty of care, they should not merely be passive recipients of that advice, but rather **play a role in the information gathering and decision-making process.**



A. Duty of Loyalty

The duty of care includes obligations to keep informed, remain attentive, and act in a manner that the officer or director reasonably believes is in the best interest of the organization. Typically, that means decisions must be made with “requisite care.”

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B. The Duty of Loyalty

Unlike the duty of care, which largely concerns a board's deliberative **process**, the duty of loyalty focuses on the **substance** of board deliberations—including director and officer motives, purposes, and goals.

The duty of loyalty requires each director and officer to act in good faith and in a manner that the individual reasonably believes to be in the best interests of the organization. Directors and officers must also take steps to not utilize corporate property or seize corporate opportunities for the individual's own personal benefit or the benefit of friends and families. As a result, in practice, the duty of loyalty's most common target is insider self-dealing or self-interested transactions. Leaders of nonprofit and community-based organizations may be personally liable if they act based on their own self-interest in a way that does not serve the organization's interests.

Dan Dogood is the Executive of Charitable Services, Inc. (“Charity”) and also serves as the chairman of the Charity fundraising committee. Each year, Charity hold an auction that accounts for the vast majority of Charity's annual fundraising. In recognition of Charity's mission, local businesses provide goods for free to Charity to auction off. An avid wine connoisseur, Dan was pleased to learn that a local wine store was donating \$1,000 worth of fine French wines. Figuring that no one would notice a missing bottle or two, Dan took two of the bottles for his home collection. As the bottles had a retail value of \$100 each, Dan donated an extra \$200 to the charity from his salary. During the auction, the other wine bottles donated to the auction sold for \$250 each—\$150 more than had been expected. Did Dan violate the duty of loyalty?

Yes, Dan violated the duty of loyalty. Under the duty of loyalty, a corporate fiduciary has the duty. to not utilize corporate property for personal gain. Here, Dan utilized corporate assets (in this case, the opportunity to sell wine donated for use by the charity) for his own personal benefit.

C. The Duty of Obedience.

Unlike the fiduciaries of for-profit enterprises, the directors and officers of nonprofit and community-based organizations also must adhere to a third fiduciary duty—the so-called “duty of obedience,” which requires the directors and officers of a nonprofit or community-based organization to carry out the purpose and mission of the organization, as expressed in the governing legal documents.

William Goodwill was a wealthy entrepreneur who specified in his will that, Goodwill Manor, his personal residence—a sprawling mansion and grounds—would be forever used as a public park and community center. In accordance with his will, Goodwill Manor has hosted community events for over 150 years. Recently, however, Goodwill Manor has fallen on hard times, and its executive director and board are considering filing for bankruptcy. After hearing that Goodwill Manor is in distress, Mega Corp., which sponsors a charity that takes in stray dogs, approaches Goodwill Manor's management and offers to purchase Goodwill Manor for \$1 million. Mega Corp.'s proposed purchase price is enough to pay off Goodwill Manor's creditors in full. In doing so, however, Goodwill Manor would lose its sole asset and the neighborhood where it is located, which is an impoverished neighborhood in a major metropolitan area, would lose an important community-building resource. Hundreds of stray dogs, however, would have a warm home to live in. Will Goodwill Manor violate the duty of obedience if it accepts Mega Corp.'s offer?

Although the issue is not free from doubt, it is possible that Goodwill Manor's directors and officers would violate the duty of obedience by accepting Mega Corp.'s offer because in doing so they contravene Goodwill Manor's historical mission of providing a community center for neighborhood residents. As a result, rather than immediately accepting Mega Corp.'s offer, Goodwill Manor should search the market for other potential purchasers that would utilize the Goodwill Manor facility in a manner that is closer to its intended mission.

III. What Happens When Decisions are Challenged?—The Business Judgment Rule as a Protective Standard.

So long as directors and officers take the proper steps in exercising their fiduciary responsibilities, and avoid self-dealing, they will likely be shielded from personal liability—even if their decisions turn out to be “bad”—by the so-called “business judgment rule.”

The business judgment rule, which applies to directors and officers of both nonprofit organizations and for-profit companies, is a presumption that nonprofit decision-makers have acted on an informed basis, in good faith, and with the honest belief that their decisions and actions were in the best interests of the organization and its stakeholders.

The business judgment rule's protections may be lost if, among other things, the officer or director:

- fails to disclose a conflict of interest;
- engages in self-dealing or usurps opportunities that belong to the nonprofit;
- fails to stay informed;
- disregards the organization's established decision making process;
- commits fraud; or
- recklessly ignores red flags that a director or officer, acting reasonably, would heed.

Where the business judgment rule's protections are lost, the burden is on the directors and officers to prove the “entire fairness” of transaction or decision in question to the organization. Doing that can be challenging, especially when a court is evaluating a “bad” decision with the benefit of 20/20 hindsight.

A board must understand that its actions are likely to be under increased scrutiny during difficult financial times. And the board's decisions may be later examined by creditors or a court with the benefit of hindsight.

None of this means that directors and officers must eliminate business risk when the organization is insolvent—the business judgment rule still applies—but the risks undertaken must be reasonable and the course of action chosen must be reasonably achievable and reassessed as new facts develop.

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As the president of a local food bank, Paul Prescott is responsible for selecting vendors to provide goods and services to the food bank. As a charity with limited resources, however, the food bank must carefully screen proposals from vendors to ensure that it does not exceed its annual budget. Recently, the food bank's management determined that it could substantially reduce its costs by outsourcing its information technology function to a third-party vendor. Paul approaches his sister, Polly, about submitting a proposal. Although Polly's prices are below market, which would make her a competitive contender for the engagement, Paul is concerned that the board of directors—which must approve the contract—will be dissuaded from hiring Polly if they know that she is related to Paul. To eliminate the appearance of impropriety, Paul asks Polly's business partner to submit the proposal in her name and to conceal the connection with Polly. Polly's partner submits the proposal and is selected as the food bank's new information technology service provider. Will the board's decision to hire Polly's firm be subject to the business judgment rule?

No. Typically, corporate decisions are subject to the business judgment rule, a highly-deferential standard that protects corporate decision making. But Paul failed to disclose a conflict of interest and, as a result, he is not entitled to protection under the business judgment rule and the food bank's transaction with Polly will be subject to greater scrutiny in the event the charity's use of Polly's firm somehow causes damage to the

IV. How Does a Nonprofit Organization's Solvency Affect the Fiduciary Duties of Directors and Officers?

When a nonprofit or community-based organization is solvent, directors and officers owe their fiduciary duties to the organization and to the organization's noncreditor stakeholders, including its donors and sponsors. An insolvent organization, however, also owes duties to its **creditors**, as its creditors bear the risk of not being repaid if the organization fails.

When a nonprofit is insolvent, or nearly so, it generally is not prudent for the board to authorize a high risk/high reward transaction that may threaten creditor recoveries. A board must understand that its actions are likely to be under increased scrutiny during difficult financial times. And the board's decisions may be later examined by creditors or a court with the benefit of hindsight.

None of this means that directors and officers must eliminate business risk when the organization is insolvent—the business judgment rule still applies—but the risks undertaken must be reasonable and the course of action chosen must be reasonably achievable and reassessed as new facts develop.

V. General Guidelines for Complying with Board Members' Legal Responsibilities.

Duty of Care	Duty of Loyalty	Duty of Obedience
<ul style="list-style-type: none"> ✓ be familiar with the organization's finances and activities and participate regularly in its governance ✓ attend all board and committee meetings and actively participate in discussions and decision-making such as setting of policies ✓ carefully read board materials ✓ where appropriate, engage and receive advice from professional advisors ✓ allow time to meet with senior management present ✓ read the minutes of prior meetings and all reports 	<ul style="list-style-type: none"> ✓ act with a single eye to the interests of the organization ✓ disclose any potential conflict of interest prior to joining the organization ✓ develop a written conflicts of interest policy so that all members are aware of the type of transaction that may prohibit them from joining the board or participating in a particular vote or decision ✓ refrain from using their fiduciary position to usurp a business opportunity or advantage available to the organization 	<ul style="list-style-type: none"> ✓ carry out the organization's mission ✓ ensure that the organization's resources are used in support of that mission ✓ refrain from engaging in unauthorized activities, such as diverting resources to other purposes other than that mission, even if such other purposes are charitable

VI. "So Can I Just Throw in the Towel?"

Everything discussed up to now may seem daunting to the average nonprofit director or officer, who oftentimes has accepted a leadership roll in the organization for altruistic reasons (the "psychic benefit"), rather than monetary compensation. Thus, it is understandable that when severe financial headwinds blow, some in leadership positions choose to resign or disengage from the organization. The problem is that what may seem an easy way out at the time can carry with it severe consequences that follow the director or officer long after the organization closes down.

The fact is, directors and officers typically have the right to resign without incurring any liability or breaching their fiduciary duties. They can resign for a good reason, a bad reason, or no reason at all, so long as they follow the organization's rules about resignations, including providing adequate notice.

What a director should not do, however, is resign (or accept the resignation of others) if, as a result, the interests of the organization would be left without proper care and protection. Resignation at such an inopportune time may result in the director or officer being held liable for breach of fiduciary duty. Moreover, resigning directors and officers may be found responsible for losses that result from their own neglect of duty before their resignation; resignation does not absolve him or her for breach of a duty.

Although an officer or director may generally resign at any time for any reason, a director's right to resign must always be qualified by his or her fiduciary duties to the organizations stakeholders, or creditors in the event of insolvency. **Further, while a director usually extinguishes his or her fiduciary duties upon resignation, a director's fiduciary duties continue for events set in motion or known about prior to resignation.**

Another thing to consider is that board members who remain at the organization and actively participate in navigating the distressed situation may be able to lessen or even eliminate their potential liability by negotiating releases with creditors and other parties.

Brian and Stacy are on the board of directors of City Greens, a nonprofit devoted to planting and maintaining trees in the city. Eighteen months ago, City Greens hired a new executive director. Since then City Greens has been struggling financially, although the executive director believes that the struggles will be temporary. The City Greens board meets several times throughout the year. Brian generally attends each meeting and is an extremely active board member. Ever since the new executive director came aboard, Brian has grown increasingly frustrated with the organization's direction, so much so that he has decided to resign his position on the board. Unlike Brian, Stacy has been so busy at her job that she has completely disengaged from her board responsibilities, having missed all but one board meeting over the past year. Though she feels guilty about her repeated absences and being "out of the loop," Stacy likes the idea of being on City Greens' board and does not want to resign, even though she knows that her schedule will not permit her to get more involved with the board anytime soon. She figures that other board members can pick up the slack and that she can always resign if it becomes certain that City Greens is failing. What should Brian and Stacy do?

Before resigning out of frustration, Brian may want to speak with fellow board members about his concerns over the organization's direction. Doing so may help change the situation and may prevent his resignation from taking the full board by surprise. If, in the end, Brian elects to resign, he should check the nonprofit's bylaws for guidelines on board resignation. Many bylaws will simply ask for a written letter. In that letter, Brian might want to explain the reasons for his resignation, including any major organizational decisions with which he strongly disagreed. As for Stacy, if she knows that she will likely continue to be an absentee board member, she should strongly consider resigning her board position sooner rather than later, following the same procedures as Brian. The longer she waits to resign, the more risk she faces if City Greens ultimately fails, including potential personal liability for losses the organization suffers as a result of Stacy neglecting her role as

VII. Strategies to Minimize Liability

The following strategies should be considered to minimize liability of directors and officers in financially distressed organizations.

- Analyze solvency regularly. Note that there are two main types of insolvency: cash flow and balance sheet. Cash flow insolvency means that the organization is unable to pay debts when they are due. Balance sheet insolvency is when the net assets of a business are worth less than the net liabilities.
- Comply with the fiduciary duties of care, loyalty, and obedience.
- Obtain professional advice as various alternatives are analyzed, including the achievability of a potential course of action.
- Do not wait until the "last minute" (e.g., do not wait until the organization is out of cash or cannot payroll) to consider restructuring alternatives or to engage advisors.
- Document the bases or reasoning underlying director and officer decision-making, including the burdens and benefits of bankruptcy.

- Complete a detailed evaluation of the business plan, challenging management assumptions and underlying data upon which the business plan is based, sensitivity analysis.
- Ensure the quality and quantity of disclosure is appropriate in light of decisions being considered by the organization.
- Gain familiarity with organizational documents, such as the organization's articles of incorporation, bylaws, and policies.
- Conduct independent audits.
- Confirm scope of, and purchase and maintain director and officer ("D&O") insurance.
- Create an indemnification policy for the organization.

Questions or Concerns?

If you have any questions about this article or need additional information about issues involving tax-exempt organizations, please contact us as tjp@thelawproject.org or 312-939-3538, or visit us online at www.thelawproject.org.