Legal Responsibilities of Nonprofit Directors

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Basic Statement of Fiduciary Duty

- Directors and Officers of a nonprofit corporation are required to discharge their duties on behalf of the corporation:
  - in good faith,
  - with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
  - in a manner the Director/Officer reasonably believes to be in the best interests of the corporation.

Components of Fiduciary Duty

- Duty of Care
- Duty of Loyalty

Duty of Care

- Preparation and participation
- Business Judgment Rule
- Delegation to committees

Duty of Loyalty

- Conflicts of Interest
  - A conflict of interest arises when a Director's/Officer’s personal or financial interests, or duties owed to another organization, conflict with her fiduciary responsibilities to the corporation.
  - "When personal interests diverge from the corporation's interest, a conflict of interest arises. Northeast Harbor Golf Club v. Harris, 725 A.2d 1018 (Me. 1999)

Conflicts of Interest

- Maine Nonprofit Corporation Act:
  - A conflict-of-interest transaction is a transaction in which a Director or Officer of a corporation has a direct or indirect financial interest.
  - An indirect financial interest exists if:
    - Another entity in which the Director/Officer has a material interest or in which the Director/Officer is a general partner is a party to the transaction; or
    - Another entity of which the Director/Officer is a Director, Officer or Trustee is a party to the transaction.

Conflicts of Interest: Specific Examples

- Interlocking directorates
- Corporate opportunities
- Competing with corporation
- Compensation for services rendered to corporation
- Use of inside information
- Loans to Directors (<u>Don’t do this</u>!)
- Board composition restrictions for public benefit corporations

Addressing Conflicts of Interest

- Maine law: Conflict of interest transaction ***is not*** voidable or grounds for imposing liability on a Director or Officer ***if*** the transaction was fair at the time it was entered into or is otherwise approved

Addressing Conflicts of Interest

- A conflict of interest transaction may be approved ***before or after*** it is completed:
- Board of Directors (or a committee) may authorize, approve or ratify a conflict of interest transaction
  - if the material facts of the transaction and the Director's/Officer's interest are disclosed or known to the Board (or committee); and
  - if it is fair and equitable to the corporation as of the date the transaction is authorized, approved or ratified (only for public benefit corporations).

Addressing Conflicts of Interest

- Statute does not require an interested Director or Officer to recuse herself from the Board's consideration of a conflict of interest transaction
- However, the objective should be to avoid even the appearance of a conflict of interest
- Best Practice: <u>Disclose and Recuse</u>!!!!!

The Intermediate Sanctions Statute

- Conflicts of interest through the lens of the federal tax law
- Applies to 501(c)(3) and 501(c)(4) tax-exempt organizations
- Provides a means to enforce private inurement prohibition without revoking organization's tax-exempt status

The Intermediate Sanctions Statute

- General Rule: The statute imposes "penalty excise taxes" in any instance where an "applicable tax-exempt organization" engages in an "excess benefit transaction" with a "disqualified person"
- Who's at risk, and for what? *Individuals, and not the organization itself, are personally liable for penalty excise taxes.*

The Intermediate Sanctions Statute

- Disqualified Persons:
  - First-tier tax = 25% of the amount of "excess benefit"
  - Second-tier tax – 200% of "excess benefit" if transaction not "corrected" within the "taxable period"
- Organization Managers:
  - Potentially liable for excise tax = 10% of "excess" benefit if they "knowingly" participate in an excess benefit transaction

Keys Terms and Concepts

- "*Applicable tax-exempt organization*"
  - 501(c)(3) and 501(c)(4) organizations
- "*Disqualified person*"
  - person who is or was at any time during 5-year period preceding transaction in a position to exercise substantial influence over the organization's affairs (e.g., Directors, senior executives, etc.)
  - member of any disqualified person's family, and any entity in which disqualified persons directly or indirectly own more than a 35% interest

Keys Terms and Concepts

- "*Organization Managers*"
  - Officers, Directors or Trustees, or individuals with similar responsibilities regardless of their title
- "*Excess Benefit Transaction*"
  - Transaction in which an applicable tax-exempt organization provides an economic benefit, either directly or indirectly, to a disqualified person, where the value of the economic benefit exceeds any value the organization receives in return
  - Non-fair market value transactions

How To Avoid Liability

- Rebuttable Presumption of Reasonableness
  - Organization can establish rebuttable presumption that a given transaction between it and a disqualified person is not an excess benefit transaction:
    - Transaction must be approved in advance by organization's Board (or committee) without the participation of any individuals who have conflict of interest with respect to the transaction
    - Board (or committee) must obtain and rely upon appropriate data as to comparability prior to making its determination
    - Board (or committee) must adequately document the basis for its determination concurrently with making the determination