Educational Materials

Wednesday October 8, 2014 2:00 PM - 4:00 PM

Pro Bono Service on a Board of a Not for Profit in Crisis/Fulfilling Your Not For Profit's Mission During Financial Distress.

In memoriam of U.S. Bankruptcy Judge Nancy Dreher, District of Minnesota.

AMERICAN BAR ASSOCIATION
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National Conference of Bankruptcy Judges

Chicago, Illinois

Wednesday, October 8, 2014

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Jointly Sponsored by the Pro Bono Services, Abuses of Bankruptcy Process, Health & Non-Profit, Insurance, and Professional Ethics Subcommittees of the Business Bankruptcy Committee

PRO BONO SERVICE ON A BOARD OF A NOT FOR PROFIT IN CRISIS FULFILLING YOUR NOT FOR PROFIT'S MISSION DURING FINANCIAL DISTRESS

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HULL HOUSE ASSOCIATION
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Jane Addams Hull House Association, a/k/a Hull House Association, provided social services to Chicago-area residents for over 120 years after its founding in 1889 by Jane Addams, one of the pioneers of social work and co-winner of the 1931 Nobel Peace Prize. Hull House filed a Chapter 7 bankruptcy proceeding in early 2012, and the liquidation of its assets is nearly complete.

In short, the work required to handle the Hull House Chapter 7 proceeding was similar to that required in the liquidation of any business which has filed for bankruptcy. That said, special consideration had to be given to (1) the sale of intellectual property; and (2) potential claims against the directors and officers of Hull House.

Hull House was one of the leading providers of social services in the Chicagoland area. At the time it was founded, it served as a settlement house for recently arrived European immigrants. Over time, it because one of Chicago's largest not-for-profit social welfare organizations. Prior to the time it closed its doors, Hull House had more than fifty programs at over forty sites, serving approximately 60,000 community members on an annual basis. Its programs included child care, domestic violence counseling, job training, housing assistance, and services for senior citizens. Prior to the bankruptcy filing, Hull House management transitioned nearly all of those programs to other social service providers and thus maintained continuity for the vast majority of the people who it served.

Hull House filed for bankruptcy for a number of reasons, not the least of which was the collapse in donations during the Great Recession of 2008-09 combined with reductions in government funding for programs. In the early years of this century, Hull House relied on government aid for approximately 85% of its budget, which was in excess of $20 million but was substantially lower than it had been in previous years. This severe decline in Hull House's revenue limited Hull House's ability to meet its obligations.

Those obligations were, in a word, substantial. At the time of the filing, Hull House had an ownership interest in real estate at 1030 W. Van Buren in Chicago, on the near west side, an ownership interest in real estate at 500 E. 67th Street in Chicago, on the south side, an ownership interest at 4520 N. Beacon Street in Chicago, on the north side and multiple leases at locations throughout the city. In addition, Hull House had operations at other facilities which operated without leases.

The real estate that Hull House owned was subject to mortgages, the largest of which was on the Van Buren location. That location formerly housed a trading operation, and had substantial floor space in an up and coming area of the city. The Van Buren location was subject to a note and mortgage of approximately $14 million. The Beacon location was the subject of a note and mortgage of $1.8 million. Unfortunately for Hull House, it took on these substantial real estate obligations in 2006 and 2007, at the height of the real estate market.

The combination of substantial obligations and a substantial drop in revenue led Hull House's directors and officers to consider options. In connection with that, it hired an outside restructuring consultant and attempted to restructure its debt. That effort did not succeed.

As a result, on January 19, 2012, the Hull House Board announced that the organization would close and file for bankruptcy. Soon thereafter, the programs were transitioned and the 300 employees, many of whom had worked for the organization for many years, were dismissed.

When the case was filed, the Trustee's first task was to assess the state of Hull House's business. To that end, the Trustee reviewed the state of the program transfers, examined Hull House's primary location on Van Buren to determine the state of its recordkeeping, and evaluated potential claims which could be the source of recovery for the Hull House bankruptcy estate.

Once the Trustee took those initial steps, the process of administering the Estate commenced. The Trustee gathered those books and records, as well as computers, which were accessible and which provided information which would be useful to the Estate, and abandoned the remaining books and records as they had no value to the Estate. After determining that the real estate had no equity, the Trustee abandoned Hull House's interest in that real estate as well. The Trustee determined that the costs associated with the liquidation of personal property, primarily furniture, exceeded the likely benefit to the Estate, and abandoned that property as well. The Trustee communicated with the Chief Restructuring Officer to determine what accounts receivable existed, if any, as well as with counsel for Hull House's secured creditor to determine whether the creditor had liens on any assets. In addition, the Trustee communicated directly with various governmental organizations and taxing entities with which Hull House did business.

To marshal the assets of the Estate, the Trustee (1) collected all accounts receivable; (2) sold the Estate's rights, if any, in the Hull House name to Metropolitan Family Services, another social service organization which had taken over much of Hull House's programming; and (3) proceeded to make a demand against the Directors and Officers of Hull House through the use of contingency fee counsel.

To liquidate the assets of the Estate, the Trustee initiated the process of claim filing and objection. In this case, a substantial amount of claims were filed by or on behalf of union members who worked at Hull House, for damages relating to unpaid wages, accrued vacation time, unpaid expenses, and other benefits, on a priority basis. In addition, the Trustee obtained the approval of an independent plan fiduciary to wind up Hull House's 401(k) and 403(b) plans. Though the funds in those plans are not property of the Estate, the Trustee had an obligation under 11 U.S.C. § 704(a)(11) to perform the obligations of the administrator and, thus, wind up those plans.

In deciding whether to investigate and/or pursue a D&O claim in a not-for-profit bankruptcy, a trustee will look for indications that the directors and/or officers might have breached their duties to the corporation and/or the creditors of the corporation. What are those duties?

I. The Fiduciary Duties Of Directors And Officers Of A Not For Profit Corporation.

Boards of directors of not-for-profit corporations, like most boards of directors, are responsible for the management of the corporation's business and affairs. In managing the business and affairs of a corporation, boards of directors act in a supervisory role, delegating the details of the day-to-day management to the officers of the corporation. While the officers have the authority and responsibility to direct and control the daily activities of the corporation, the directors have the ultimate authority and responsibility over the management of the corporation through their ability to hire, supervise and replace the corporation's officers as well their required approval of all major acts of the corporation.

As a matter of law, directors and officers owe fiduciary duties to both the corporation and to its creditors as a whole (upon becoming insolvent or entering the "zone of insolvency").[1] The law imposes two primary types of fiduciary duties owed by officers and directors: (1) the duty of care; and (2) the duty of loyalty.

A. The Duty of Care

The duty of care requires directors and officers to act prudently in light of all reasonably available information in managing and overseeing the corporation's business and making decisions on its behalf. Officers have a duty to manage the operations prudently and reasonably. Directors have a duty to oversee and supervise the corporation's management. In this regard, directors have a duty to: (1) review and monitor the performance of the chief executives and other senior officers; (2) understand the corporation's financial statements and monitor related controls; (3) implement and monitor reporting and information systems to check for failures (such as a failure to comply with laws and regulations); and (4) otherwise fulfill their fiduciary duties.

B. The Duty of Loyalty

In addition to the duty of care, directors and officers owe a duty of loyalty to the corporation. The duty of loyalty requires directors and officers to act in good faith, in the best interests of the corporation. The duty of loyalty can be breached when there is a conflict of interest, such as when an officer's or director's judgment is compromised by his or her personal interest in a decision.

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[1] The considerations of officers and directors change when a corporation becomes insolvent. When a corporation becomes insolvent, the creditors' interests become at risk. Therefore, upon becoming insolvent, the duties of officers and directors shift to include protecting the interests of the creditors.

II. Certain Officers And Directors Of Not For Profit Corporations Receive Statutory Restrictions On Liability.

The federal government, as well as many states, have enacted statutes to give additional protection from personal liability to certain officers and directors of not-for-profit corporations. Generally, these restrictions apply only to volunteers who receive little or no compensation in exchange for their services.

The federal Volunteer Protection Act provides such restrictions. See 42 U.S.C. § 14501, *et seq*. In Illinois, the General Not For Profit Corporation Act also provides similar restrictions. See 805 ILCS 105/108.70. However, there are exceptions to the restrictions created by these statutes which often include either gross negligence or wilful and wanton conduct. Therefore, directors and officers of not-for-profit corporations typically remain liable for breaches of their fiduciary duties if their conduct is either grossly negligent or willful and wanton.[2]

III. Items Bankruptcy Trustees Look For When Deciding To Pursue D&O Claims Against Directors And Officers Of Not-For-Profit Corporations

A bankruptcy trustee typically inherits the right to bring D&O claims on behalf of the bankruptcy estate and its creditors. In deciding whether to pursue D&O claims, a bankruptcy trustee of a not-for-profit corporation will often look for the same type of information as a bankruptcy trustee in any other case. However, when reviewing the facts and evidence related to a not-for-profit corporation, a bankruptcy trustee will pay special attention to any acts or omissions which constitute exceptions to the statutory restrictions on liabilities given to volunteers of not-for-profit corporations. See *supra*. For example, the bankruptcy trustee will look for breaches of duty by officers or directors who were compensated for their services. In lieu of that, the bankruptcy trustee of a not-for-profit corporation will look for grossly negligent or wilful and wanton conduct.

A. Examples Of Items To Look For When Investigating D&O Claims.

Examples of items to look for include:

1. Compensation Records – who, if anyone, is entitled to the volunteer limitations on liability?
    a. Were the officers and directors paid for their services and, if so, how much
        i. Tax returns
        ii. Salary records
        iii. Expense reports

[2] In addition, if there is a breach of the duty of loyalty, these restrictions may not apply at all.

2. Articles Of Incorporation / By-Laws – Did the corporate structure create any conflicts of loyalty?
    a. State of Incorporation/ applicable law
    b. Procedures in writing that were required to be followed
    c. Additional limitations on officer and director liabilities

3. Minutes of Meetings – Did any acts or omissions constitute a breach of duty?
    a. Board Meetings
        i. Were meeting held
        ii. What issues were discussed/decided at meetings
        iii. What acts were taken intentionally (wilfully)
        iv. What acts were taken that might have been "wanton" or grossly negligent
        v. Who attended meetings
        vi. Did any director abstain from voting or resign
        vii. Did anyone object to acts taken by officers or directors
    b. Committee Meetings
        i. Who is on what committee
        ii. Was the recommendation of the committee followed by the Board
        iii. If not, why not

4. Board "Packets" – what were important issues and what was given to directors?
    a. Agenda items
    b. Financial Statements
    c. Prior Minutes and related issues

5. Financial Statements – When did corporation become insolvent or enter the "zone of insolvency"?
    a. Audited / Internal
    b. Going concern language
    c. Footnotes

6. Expert Reports – What experts were retained and what did they recommend?
    a. Quality of experts and reports
    b. Topics and limitations

7. Audits – what did other experts find / were any problems with the corporation identified and brought to the attention of the officers or directors?
    a. Financial
    b. Internal
    c. External
    d. Government

8. Policies And Procedures – did officers and directors follow internal written procedures?
    a. Officers duties and responsibilities
    b. Document destruction
    c. Confidentiality

NATIONAL CONFERENCE OF BANKRUPTCY JUDGES
AMERICAN BAR ASSOCIATION
CHICAGO, OCTOBER 8, 2014
NON-PROFITS IN BANKRUPTCY

Raymond T. Lyons

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Religious Organizations in Bankruptcy

Governance

Any organization entering bankruptcy may have issues regarding governance - religious organizations are no exception. There may be factions among the directors that disagree on how the organization should be run. Contested elections may arise. The officers and the board may be at odds. Generally, civil courts will not interfere with ecclesiastical practices, matters of faith, doctrine or governance of religious organizations

Hosanna-Tabor Evangelical Lutheran Church and School, 132 S.Ct. 694 (2012). Teacher and Equal Employment Opportunity Commission (EEOC) sued church and school claiming discrimination based on disability. Held: "Ministerial Exception" grounded in Religion Clauses of First Amendment operates as an affirmative defense to employment discrimination claim. "Called" teacher, who received special religious training and is considered to be called to a teaching vocation by God, is a minister. The Establishment and Free Exercise Clauses of the First Amendment bar suits by ministers against their religious organizations claiming employment discrimination. Requiring a church to accept or retain an unwanted minister, or punishing a church for failing to do so, intrudes upon more than a mere employment decision. Such action interferes with the internal governance of the church, depriving the church of control over the selection of those who will personify its beliefs. "Both Religion Clauses bar the government from interfering with the decision of a religious group to fire one of its ministers. . . The Establishment Clause prevents the Government from appointing ministers, and the Free Exercise Clause prevents it from interfering with the freedom of religious groups to select their own."

Serbian Eastern Orthodox Diocese for United States and Canada v. Milivojevich, 426 U.S. 696 (1976). Bishop who had been removed from office challenged his removal in court. The Illinois Supreme Court reinstated bishop because the removal proceedings failed to follow church rules. The U.S. Supreme Court reversed. The First Amendment permits hierarchical religious organizations to establish their own rules and regulations for internal discipline and government, and to create tribunals for adjudicating disputes over these matters. When ecclesiastical tribunals decide such disputes, the Constitution requires that civil courts accept their decisions as binding upon them.

Kedroff v. St. Nicholas Cathedral of Russian Orthodox Church in N. Am., 344 U.S. 94 (1952). Conflict between archbishop of Russian Orthodox Church appointed by the North American churches and archbishop appointed by the patriarch in Moscow over use of cathedral in New York City. Held: New York statute requiring every Russian Orthodox Church in New York to recognize the determination of the North American churches violated the First Amendment. Religious organizations have freedom “to decide for themselves, free from state interference, matters of church government as well as those of faith and doctrine.” Decision of the ruling authorities in Russia must be respected by legislature and courts.

Property

Religious organizations may encounter issues as to what constitutes property of the estate and the use or control of property. Courts will exercise jurisdiction where neutral principals of law may be applied without infringing on ecclesiastical matters, such as by interpreting deeds, trusts, or state statutes under principals familiar to lawyers and judges.

Watson v. Jones, 80 U.S. 679 (1871). Dispute between antislavery and proslavery factions over control of church property. The General Assembly of the Presbyterian Church recognized the antislavery faction. Applying not the Constitution but a broad and sound view of the relations of church and state, the Court declined to question that determination. Courts can resolve intra-church property disputes by deferring to decisions of the highest authority of a hierarchical church. “[W]henever the questions of discipline, or of faith, or ecclesiastical rule, custom, or law have been decided by the highest of church judicatories to which the matter has been carried, the legal tribunals must accept such decisions as final, and as binding on them.”

Jones v. Wolf, 443 U.S. 595 (1979). Majority of congregation in local incorporated church voted to leave national church. Regional church group ruled that minority were the true local congregation. Minority sued in state court to regain control of local church property from majority. State court held that title to property was in incorporated local church applying state property law and that majority controlled local church. U.S. Supreme Court reversed and remanded for determination of control issue applying neutral principals of law. “[T]he First Amendment prohibits civil courts from resolving church property disputes on the basis of religious doctrine and practice.” “[T]he Amendment requires that civil courts defer to the resolution of issues of religious doctrine or polity by the highest court of a hierarchical church organization.” States may apply neutral principles of law such as the language of deeds, the terms of local church charters, state statutes governing property and the constitution of the general church concerning control of church property. “The method relies on objective, well-established concepts of trust and property law familiar to lawyers and judges.”

In re Archdiocese of Milwaukee, 485 B.R 385 (Bankr. E.D. Wis. 2013). Archdiocese (Debtor) had transferred $55 million to a cemetery trust less than three years prior to filing chapter 11. Archbishop, as trustee of a cemetery trust, sought declaratory judgment that cemetery trust funds are not property of the bankruptcy estate or that attempts to treat cemetery trust funds as property of the estate would violate the Religious Freedom Restoration Act (RFRA) and the First Amendment to the U.S. Constitution. The bankruptcy court held:

1. RFRA applies to government actors, not private parties.

2. The Official Committee of Unsecured Creditors is not a government actor.

> 3. Determining whether the cemetery trust fund is property of the estate under 11 U.S.C. § 541 involves application of neutral, generally applicable law and does not violate the Free Exercise Clause of the First Amendment.

In re Archdiocese of Milwaukee, 496 B.R 905 (E.D. Wis. 2013). District court reversed. A debtor in possession is an officer of the court and the Committee, acting through a grant of derivative standing, is likewise an officer of the court. Prosecuting an avoidance action is a public function. The Committee, exercising authority granted to it by the bankruptcy court, acts under color of law and is subject to RFRA. Both RFRA and the First Amendment prevent the Committee from seeking funds in the cemetery trust because it would substantially burden the trustees' free exercise of religion. Catholics believe in the resurrection of the body and perpetual care of sacred cemeteries is a core belief. Even if the bankruptcy code is facially neutral, its application must not substantially burden the free exercise of religion unless there is a compelling government interest justifying the burden.

In re Roman Catholic Archbishop in Portland, 335 B.R. 842 (Bankr. D. Or. 2005). Debtor, a corporation sole, held legal title to extensive real and personal property, including properties used by parishes and high schools. "[T]he question of whether property is part of the bankruptcy estate under the Bankruptcy Code does not require that [the court] resolve matters of faith, doctrine, or governance." "[A] religious organization's property rights are governed by state law, not internal church law." "[O]regon's corporation sole statutes do not require application of canon law in determining interests in church property under state law." Parishes could be incorporated separately under Oregon law, but were not. Any burden on the exercise of religion is attributable to the choice of civil organization made by the debtor. The parishes and schools are not separate entities, but part of the debtor.

Committee of Tort Litigants v. The Catholic Diocese of Spokane (In re Catholic Bishop of Spokane), 329 B.R. 304 (Bankr. E. D. Wash. 2005), *aff'd in part* 2006 WL 211792 (E.D. Wash. Jan. 24, 2006) *rev'd in part* 364 B.R. 81 (E.D. Wash. 2006). Committee of Tort Litigants sued for declaration that property used by parishes constitutes property of the debtor's estate. "This controversy is inherently different (from intra-church disputes). It involves the rights of creditors of the religious organization, not disputes among its members or component parts." Bankruptcy Court held that it could apply neutral principals of state law to determine that the debtor held title to all property in trust for the entire diocese, not particular parishes. If the First Amendment deprives the bankruptcy court of jurisdiction to determine what is property of the estate in a voluntary case, the remedy may be dismissal. District court reversed the grant of summary judgment in favor of the Committee finding that the undisputed evidence showed that individual parishes paid for acquisition of real property and erection of church and school buildings. The bankruptcy court erred in not considering these facts in rejecting the parishes claim to beneficial ownership of parish properties.

Highest and Best Offer

In re United Healthcare System, Inc., 1997 WL 176574 (D.N.J. 1997). Hospital informed State Commissioner of Health that it was experiencing dire financial problems. Commissioner directed hospital to seek a buyer within a month. Bids were received. The hospital board selected one of the bidders and entered into a contract of sale, contingent on the hospital filing bankruptcy and court approval of the sale. The Commissioner issued new certificates of need to the buyer. The bankruptcy court held that the board did not properly exercise its business judgment and that the bankruptcy court could entertain a competing offer that would yield more money for creditors. It denied the motion to sell, voided the contract and directed the debtor to seek extensions of its certificates of need from the Commissioner. The district court reversed. "When analyzing an articulated business reason for the sale, the bankruptcy court must also take into consideration the fact that a debtor is a charitable institution. . . The officers and directors of a non-profit organization are charged with the fiduciary obligation to act in furtherance of the organization's charitable mission. In addition, the law allows the bankruptcy court to entertain higher and better offers, which means that the bankruptcy court may not focus solely on price."

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Non Profit D&O Insurance

Standards of conduct for a Non-Profit board varies by the nature of their services but nevertheless everyone have the personal liability exposure. A common misconception that General Liability policy would extend coverage to their D&O wrongful acts is not true. A GL policy provides coverage when the non-profit organization or its employees or volunteers or board members negligently cause someone "bodily injury, personal injury or property damage". All too often the Board of Directors foregoes purchasing a Directors & Officers insurance policy to save on expenses and their personal assets are in line.

Even if the Board is protected by state immunity and rely on the fruits of their good deeds, they may incur legal defense expenses until they prevail in the courts. It is common nowadays for non-profits to operate more as a business due to donor pressure.The common wrongdoing allegations against the board members are Discrimination (age, race, sex, employment, membership), Harassment, Wrongful termination of employees, waste of assets, Misleading reports or other misrepresentations, Libel and slander, Failure to deliver services, failure to supervise, executing beyond the granted authority. The costs of defending an organization and its members can be astronomical with average cost ranging from $35,000-$75,000.

D&O insurance should be a must expense since many non-profits are being sued. It is a fact that the cost of defending a claim by the insurance carrier is always lower than that when there is no insurance coverage. Even if an organization promises to indemnify its board members, it is only as good as the availability of funds. When a non-profit organization is financially distressed, the probability of wrongful acts allegations multiply tremendously. D&O coverage premiums are relatively low for the broad protections provided by the policy.

Understanding key policy provisions

Broad definition of insured

Look at the definition of the insured. D&O liability policy should cover all past, present and future directors, officers, employees, volunteers and committee members. If the organization and the employees are not named insureds, the policy offers narrow coverage and their insurance broker should ask their carrier to endorse the broad coverage.

Coverage Limits

Coverage limits are determined by the insured's financial size. They range from $1MM to $10mm typically and larger organizations can build higher limit towers based on their needs. Typical rule of thumb is 1.5 times their financial size and most common limit purchased is $1MM. Occasionally carriers will offer higher limits for smaller organization when a high profile board member demands the limits to protect his/her personal assets.

Duty-to-Defend Coverage

Most non-profit D&O policies are written on a "duty-to defend" basis meaning that the insurer has the duty to defend the insured, and pay settlements /judgments, up to the limit purchased. Insurers will have a panel of approved defense counsel law firms. If the insured is in a different state than the approved counsel, they can endorse to get choice of counsel or opt out of duty to defend provision.

Punitive Damages

Policy's definition of "loss" or "damages " will describe whether punitive damages are afforded coverage under the policy and if punitive damages are covered subject to statutory law provisions governing such insurability. Policies having most favorable venue wording is desirable to get the best provision.

Defense expenses

Subject to underwriting considerations, carriers will offer defense expense in addition to the policy limits of liability. The organization need not worry about the limits for damages when they have additional limits for claims expenses.

Broad Policy definition of Employment Practices Liability

While D&O claim severity is high, EPL claim frequency is high for the Non-Profit Organization. Though most D&O policies extend coverage to Employment practices, the payment of such EPL claims will erode the policy limits. For a financially distressed non-profit, layoffs and involuntary terminations maybe imminent which may lead to EPL claims and allegations.

Failure to maintain Exclusion

Insurers may attach exclusionary language that will eliminate coverage for any claim situation where insurance could have been purchased but was not.

Severability provision

Severability provision protects the innocent persons and preserve the D&O coverage for them even if there is fraud or financial manipulation by one or more of the covered persons.

Additional Side A Coverage

Policy limits should have additional coverage limits for Directors & Officers. In the event of a bankruptcy, D&O insurance policy may be frozen. Side A coverage is payable directly to the directors and officers, whereas Side B coverage is payable to the corporation for claims of wrongful acts by directors and officers. Side C is payable directly to the entity for its wrongful acts.

Order of Payments – Policy language should have priority of payments language where it provides that the policy proceeds will be paid first for the directors and officers and only thereafter for the non-profit organization.

In conclusion, Non Profit D&O insurance is cost effective and affordable to all charitable organizations. It is not a simple insurance but more complex with policy language that needs to focus on protecting the Directors & Officers when a claim arises for whatever the cause may be. Robust D&O insurance will help the Directors & Officers to continue their services without worrying about their personal liability.

NON-PROFIT ORGANIZATIONS: BASICS AND D&O LIABILITY

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NONPROFIT/TAX EXEMPTION BASICS

Nonprofit organizations (hereafter referred to as "NPOs"), are best identified by their properties in a state corporate law context, under federal and state tax law, and by their orientation as a public charity or a private foundation (also known as "donative nonprofits"). This section will examine NPOs through the basics of their organizational properties, operations, and leadership, as well as through comparisons with for-profit organizations.

I. Nonprofit

In the state corporate context, an NPO's purpose is not primarily to earn a profit, but rather to achieve some goal designated in its mission/purpose. As a result, any surplus revenue the organization collects in its operation is invested back into the mission (through funding its self-preservation, expansion, etc.) instead of as profits or dividends for owners and/or stake holders. In fact, there are no legally recognized "owners" in an NPO. Even if the organization as a whole were to fail, its assets are permanently dedicated to its exempt purpose until they've been exhausted. These organizations can consist of corporations, limited liability companies, trusts, or associations.

a) Tax Exemption

An NPO is not automatically tax exempt under state or federal tax law. The Internal Revenue Service must first designate an eligible NPO under the tax classification of 501(c). There are twenty-eight 501(c) designations, however, this document only addresses those that are 501(c)(3) or "public charity organizations". Donations to NPOs designated as 501(c)(3) are deductible to the donor on their individual tax returns. NPOs that receive the 501(c) designation from the IRS are exempt from paying corporate income taxes on income generated from activities substantially related to their exempt purpose; however, NPOs are not exempt from taxes on activities that are not directly related to their purpose, such as employment taxes and unrelated business income. Additionally, while under this tax exempt status, any member having substantial influence over the organization that engages in an excess benefit transaction (i.e. they receive a personal economic benefit from the NPO greater than the consideration received by the NPO for providing the benefit), an excise tax may be imposed on the person and any organization managers agreeing to the transaction. 501(c) designated NPOs also can not engage in any political activity, except legislative (lobbying) activity, which cannot represent a substantial amount of their organizational time and money.

b) <u>Organizational Structure</u>

NPOs can be organized as a limited liability company, an association, a trust, or, the most common type, a corporation and are classified with the Internal Revenue Service as either public charities or private foundations. Public charities operate in many different areas, including but not limited to religion, science, public safety, literature, education, amateur sports competition, and prevention of cruelty to children or animals. Such charities are commonly recognizable as churches, hospitals, qualified medical research organizations affiliated with hospitals, schools, colleges, and universities. Public charities also sometimes actively function in a supporting relationship to one or more existing public charities. They have an active program of fundraising and receive income from the conduct of activities in furtherance of the organization's exempt purposes in addition to receiving contributions from many other sources including, the general public, governmental agencies, corporations, private foundations, or other public charities. Private foundations, by comparison, usually have only a single major source of funding, typically in the form of gifts from one family or corporation, instead of funding from multiple sources. The primary activity of most private foundations is making grants to other charitable organizations and to individuals, as opposed to the direct operation of charitable programs as is the case with public charities.

NPOs can further be classified by their organizational structure as either membership or board-only. In an NPO with a membership structure, the organization is controlled by the members, who elect the board of directors, hold regular meetings, and have power to amend the organization's bylaws. Membership organizations face many complexities and requirements on their decision making due to governance and structural issues. Adversely, board-only organizational structures within NPOs delegate all operational power to a board of directors who elect their own successors. Board-only NPOs can have a membership, but their powers are limited to those delegated to them by the Board. An organization's charter and bylaws may state that the organization does not have any membership, although the organization's literature may refer to its donors as "members".

c) <u>Organizational Documents</u>

There are many things to consider in the formation and structure of NPOs from a legal perspective. When creating an NPO, it is required to create organizing documents in order to be considered for tax exempt status. These documents include the organization's charter/articles of incorporation and bylaws, each including all the required provisions and governance of the NPO. The organizing documents contain the purpose of the organization and language regarding the distribution of its assets in the event of its dissolution. In further preparation for tax exempt consideration, NPOs must also file for an employer identification number from the IRS. Most states also have statutes that require an NPO that solicits donations, as many do, to register and file periodic financial reports. Finally, NPOs can also apply for property tax exemption and sales and use tax exemption on the state and local level, generally, after receiving federal tax exempt status.

d) Maintaining Tax Exempt Status

Once a nonprofit is operating with all the required initial documentation filed, there are still other organizational practices that it must continue throughout its duration to keep its tax exempt status, such as avoiding activities that would jeopardize exemption, regularly paying employment taxes, maintaining substantiation and disclosure of all charitable donations received, and meeting public disclosure requirements. An NPO can most effectively avoid jeopardizing its exempt status by ensuring the following: 1) the organization isn't being managed so as to privately benefit an individual or family, 2) there are no excess benefit transactions (which can result in an excise tax for the individual(s) involved), 3) avoid supporting any campaign/political candidate running for public office or allowing a "substantial part of its activities" to be used to attempt to influence legislation (also known as lobbying), and 4) avoiding an excessive amount of unrelated business income. Additionally, NPOs can avoid losing tax exemption by consistently and timely paying taxes through withholding federal income tax, Social Security and Medicare tax, and federal unemployment tax from employee paychecks. The IRS also imposes record keeping and substantiation rules on donors and disclosure rules on charitable organizations. It is the responsibility of the NPO to provide a written acknowledgement to the donor of the contribution received, including exchanging contributions and charity auction contributions. Disclosure is also required for noncash donations like donor property. Finally, to continue tax exempt status, tax-exempt organizations must also make annual returns and exemption applications filed with the IRS available for public inspection and copying upon request.

II. **Differences Between Nonprofit and For-Profit Corporations**

The duties of nonprofit and for-profit directors are different when addressing the NPO's revenue and assets and the organizational and operational functions; however, it is generally accepted that elements of for-profit law apply to nonprofit law. The Ohio Court of Appeals noted in *Miller v. Bargaheiser, 70 Ohio App. 3d 702, 707(Ohio Ct.App 1990)*, that "[w]hile the case law upon which this conclusion is based involved for-profit corporations, we know of no reason why these principles should not likewise be applicable to nonprofit corporations." Although the same principles of law governing for-profit corporations generally govern the activities of nonprofit corporations, directors and officers of a nonprofit corporation "have a special duty to advance its charitable goals and protect its assets." *Oberly v. Kirby, 592 A.2d 445, 472-73 (Del. 1991)*.

NPOs, as previously stated, can be a limited liability company, an association, a trust, or, the most common type, a corporation. NPOs are similar to for-profit corporations in that they both exist separate from their owners and they are both legally viewed as an "artificial person", meaning, they can own property, incur debts, sue or be sued, etc. Nonprofit and for-profit corporations differ in a number of ways, several distinctions include 1) NPOs have no private shareholders or stock, a defining quality of for-profit corporations, 2) the NPOs potential tax designation of 501(c) tax exempt organization with the Internal Revenue Service, 3) the NPOs obligation to invest all surplus revenue into the organization's self-preservation, expansion, or plans, and 4) the NPOs often volunteer or nominally-compensated staff and executives. However, the main distinction between for-profit and nonprofit entities is the possibility of private enrichment. Thus, "in general terms, a nonprofit enterprise is an organization in which no part of the income is distributable to its members, directors or officers . . . ." To be more precise,". . . one crucial feature distinguishes nonprofit corporate governance from that of for-profit corporations: nonprofit corporations are subject to the non-distribution constraint. The non-distribution constraint prevents the organization from distributing its net earnings to those in control of the corporation; . . . ." *Summers, Et Al. V. Cherokee Children & Family Services, Inc., Et Al., 112 S.W.3d 486, 500-01 (Tenn. Ct. App. 2002)*

Examples of for-profit corporations include Starbucks, Wal-Mart, and Google, and examples of nonprofit corporations include Habitat for Humanity, Goodwill, Soles4Souls and Feed the Children.

Below is a chart outlining some of the major difference between a for-profit and nonprofit corporation.

	NONPROFIT CORPORATIONS	FOR-PROFIT CORPORATIONS
Who owns the corporation?	the public	Stockholders
What is the purpose?	Serve the public	Generate money for the owners
Directors and officers	Directors and officers are usually unpaid volunteers. Owe a fiduciary duty of care and loyalty to the corporation.	Directors and officers are usually paid. Owe a fiduciary duty of care and loyalty to the corporation.
Officers income	Officers should make reasonable, and not excessive or income. Compensation committee of the corporation should ensure that the officers income is in line with similar nonprofits in the same geographic area	Officer can have a large income
Source of funding	Funding generally comes from donations and grants from individuals, governments, foundations, and other organizations	Funding generally comes from earned/passive income, investors, credit from financial institutions and suppliers
How is revenue spent?	Must spend the revenue on furthering the mission/purpose of the corporation.	Have greater leeway as to how the revenue is spent
Surplus revenue	Surplus revenue is retained as a profit and the corporation is prohibited from distributing the excess funds to any director, officer, member or any other person. The funds should be spent on furthering the charitable purpose of the organization.	Surplus revenue is kept as a profit and distributed to owners

Taxes – Federal, State and Local	Often exempt from federal taxes, and some state and local taxes. The corporation must apply for tax exempt status from the appropriate governmental agency The corporation is responsible for employment taxes, unrelated business tax, and excise taxes in certain situations. If a substantial amount of the corporation's revenue is from unrelated sources, then the corporation could lose its federal tax exempt status.	Usually not exempt from paying federal, state, and local taxes
Tax deductions	Money donated to the nonprofit can be deducted from the donor's personal tax liability if the nonprofit was granted charitable status from the appropriate government agency	Money invested in the for-profit usually cannot be deducted from the investor's personal tax liability

D&O LIABILITY

I. Fiduciary Duties

The continual smooth and successful operation of a nonprofit can largely be attributed to its leadership. As previously mentioned, NPOs are generally governed by a board of directors, usually with one person designated as a chief executive. These individuals are responsible for many duties as directors and officers, and must exercise the utmost care, loyalty, and good faith toward the corporation. The directors of a corporation have to ensure that the corporation has the benefit of their best judgment, and act with reasonable care in good faith to promote its welfare. *Summers, Et Al. V. Cherokee Children & Family Services, Inc., Et Al., 112 S.W.3d 486, 503 (Tenn. Ct. App. 2002).* Also, directors of a corporation owe fiduciary duties of care and loyalty to the corporation. These duties require that directors exercise their authority on an informed basis and in the good faith pursuit of maximizing the value of the corporation for the benefit of its stockholders. *In Re: Gulf Fleet Holdings, Inc. 2014 Bankr. LEXIS 2142*42-3*

The Model Nonprofit Corporation Act and the Revised Model Nonprofit Corporation Act both provide fiduciary duties by which directors and officers must comply.

a) Model Nonprofit Corporation Act

1. § 8.30(a)-(c). Standards Of Conduct For Directors

"(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the nonprofit corporation.

"(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, must discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

"(c) In discharging board or committee duties a director must disclose, or cause to be disclosed, to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions, except that disclosure is not required to the extent that the director reasonably believes that doing so would violate a duty imposed by law, a legally enforceable obligation of confidentiality, or a professional ethics rule." (Emphasis added)

2. § 8.42(a)-(b). Standards Of Conduct For Officers

"(a) An officer with discretionary authority must discharge his or her duties under that authority: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the officer reasonably believes to be in the best interests of the corporation.

"(b) The duty of an officer includes the obligation to inform:

(1) the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports, of information about the affairs of the nonprofit corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to the superior officer, board, or committee; and

(2) his or her superior officer, or another appropriate person within the nonprofit corporation, or the board of directors, or a committee thereof, of any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes has occurred or is likely to occur."

b) Revised Model Nonprofit Corporation Act

1. § 8.30(a). General Standards for Directors.

> "(a) A director shall discharge his or her duties as a director, including his or her duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation."

2. §8.42(a). Standards of Conduct for Officers.

> "(a) An officer with discretionary authority shall discharge his or her duties under that authority: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the officer reasonably believes to be in the best interests of the corporation and its members, if any."

These duties usually take the form in state statutes as the duty of care, the duty of loyalty, and the duty of obedience/acting in good faith.

c) Duty of Care

The Duty of Care exists to require directors to manage the organization competently. Responsibilities that fall under this duty include: setting policies and ensuring they are carried out, overseeing management, monitoring finances, including approving and monitoring the budget, establishing and promoting the mission of the nonprofit, raising the funds necessary for the NPO to fulfill its mission, ensuring compliance with laws, rules and regulations, and ensuring the board functions effectively.

In a leading case dealing with fiduciary duties, *In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 970 (Del. Ch. 1996),* the complaint charges the director defendants with breach of their duty of care in connection with the on-going operation of the corporation's business. The plaintiff claimed that the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance.

Under the duty of care, directors must assure that corporate information gathering and reporting systems exists. These systems represent a good faith attempt to provide senior management and the Board with information respecting material acts, events and conditions within the corporation, including compliance with applicable statutes and regulations

The Court opined “that a director's obligation includes a duty to attempt in good faith to assure that [a] corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.”

The duty to be informed does not require directors to possess detailed information about all aspects of the operation of the enterprise. Such a requirement would simply be inconsistent with the scale and scope of efficient organization size in the current technological age.

In order to show that a director breached their duty of care, plaintiffs have to show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy the situation, and (4) that such failure proximately resulted in the losses complained of. Ultimately, imposition of liability on a director requires evidence that the directors knew that they were not discharging their fiduciary obligations.

d) Duty of Loyalty

The duty of loyalty exists to ensure directors and officers act in a manner consistent with the best interests of the nonprofit as a whole, rather than furthering their own interest or that of any other entity, at the expense of the NPO. A few areas directors need to keep in mind when considering the duty of loyalty are: 1) avoiding conflicts of interest between directors and officers and the interests of the NPO (unless they directly benefit the NPO), 2) avoiding using corporate opportunities identified for the NPO as personal opportunities for board members and/or the director, and 3) keeping the organization’s private information confidential. Directors and officers can protect themselves from allegations suggesting they’ve violated the duty of loyalty by the following: 1) disclosing any conflict of interest they may have before the issue arises, 2) through recusal, 3) documentation, 4) advance approval, 5) professional advice, 6) keeping good minutes, and 7) exercising oversight of executives.

The duty of loyalty is transgressed when a director or officer uses his or her position to promote, advance or consummate a transaction between the corporation and himself/herself, which is not substantially fair to the corporation.

However, as a general rule, directors entrusted with the organizational responsibility over an NPO are not precluded from engaging in a business similar to that of the organization, for personal gain or otherwise, so long as they act in good faith, their activities do not directly impede the operations of the

NPO, and they do not violate any fiduciary duty owed to the corporation. Engaging in direct competition with the NPO adversely is prohibited by the duty of loyalty.

e) Duty of Obedience/Act in Good Faith

Lastly, the duty of obedience/act in good faith exists to ensure NPO leadership keeps to the organizational mission and that the organization as a whole follows all applicable laws.

Directors of a for-profit corporation have an obligation to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity. *Credit Lyonnais Bank Nederland v. Pathe Communications, C.A. No. 12150 (Del. Ch. Dec. 30, 1991)*

A failure to act in good faith may be shown, for instance, [1] where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, [2] where the fiduciary acts with the intent to violate applicable positive law, or [3] where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. *In re China Agritech, Inc., 2013 Del. Ch. LEXIS 132(Del. Ch. 2013)*

In the same way a managing officer in the for-profit sector makes decisions to ensure the company is profitable, a managing officer of a nonprofit is expected to make decisions that ensure the organization is operating to fulfill its mission effectively and follows all applicable laws.

II. Director and Officer Potential Liability

Generally, corporations provide their directors and officers with protection for their actions. However, in a few situations, people involved with a NPO can be held personally liable for its debts and other obligations. For example, a director or officer of a NPO can be held personally liable if he or she: 1) personally and directly injures someone, 2) fails to pay taxes or file necessary tax returns, 3) personally guarantees a bank loan or business debt on which the corporation defaults, 4) does something intentionally fraudulent, or illegal, or 5) co-mingles NPO and personal funds.

Directors are generally held to the gross negligence standard of care. The case that set the standard of care for trustees and nonprofit corporate directors is *Stern v. Lucy Webb Hayes Nat. Training Sch. for Deaconesses and Missionaries, 381 F. Supp. 1003 (D.D.C.1974).* This case involved the liability of “trustees” of a hospital which was organized under the laws of the District of Columbia as a nonprofit corporation. In finding liability on the part of the corporation's "trustees" (who acted as corporate directors), the court stated:

> “the charitable corporation is a relatively new legal entity which does not fit neatly into the established common law categories of corporation and trust. As the discussion below indicates, however, <u>the modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations</u>, because their functions are virtually indistinguishable from those of their "pure" corporate counterparts.” (Emphasis added)

Trustees at the time were held liable for simple negligence and a director of a nonprofit corporation was liable only for gross negligence. The Court reasoned that because the corporation's "trustees" acted as directors, they should be held to the gross negligence standard of care which is applicable to nonprofit corporate directors. The court found that each of the corporation's trustees had 1) breached their fiduciary duties when they didn’t bother “to object when no meetings [of the board] were called for more than ten years”, 2) failed to acquire adequate knowledge to vote intelligently on the opening of new bank accounts, 3) failed to "exercise even the most cursory supervision of Hospital funds", and 4) “they failed to establish and carry out a defined policy.”

Under the Model Nonprofit Corporation Act and the Revised Model Nonprofit Corporation Act, directors are personally liable to the nonprofit corporation for unlawful distributions.

a) <u>Model Nonprofit Corporation Act</u>

1. <u>§ 8.33 Directors’ Liability For Unlawful Distributions</u>

“(a) **A director who votes for or assents to a distribution made in violation of this [act] <u>is personally liable</u> to the nonprofit corporation** for the amount of the distribution that exceeds what could have been distributed without violating this [act] if the party asserting liability establishes that, when taking the action, the director did not comply with Section 8.30.

“(b) A director held liable under subsection (a) for an unlawful distribution is entitled to: (1) contribution from every other director who could be held liable under subsection (a) for the unlawful distribution; and (2) recoupment from each person of the pro-rata portion of the amount of the unlawful distribution the person received, whether or not the person knew the distribution was made in violation of this [act].

“(c) A proceeding to enforce: (1) the liability of a director under subsection (a) is barred unless it is commenced within two years after the date on which the distribution was made; or (2) contribution or recoupment under subsection (b) is barred unless it is commenced within one year after the liability of the claimant has been finally adjudicated under subsection (a).” (Emphasis added)

b) <u>Revised Model Nonprofit Corporation Act</u>

1. <u>§ 8.33. Liability for Unlawful Distributions.</u>

"(a) Unless a director complies with the applicable standards of conduct described in section 8.30, **a director who votes for or assents to a distribution made in violation of this Act <u>is personally liable</u> to the corporation** for the amount of the distribution that exceeds what could have been distributed without violating this Act.

"(b) A director held liable for an unlawful distribution under subsection (a) is entitled to contribution: (1) from every other director who voted for or assented to the distribution without complying with the applicable standards of conduct described in section 8.30; and (2) from each person who received an unlawful distribution for the amount of the distribution whether or not the person receiving the distribution knew it was made in violation of this Act." (Emphasis added)

c) <u>Fraud/Embezzlement/Theft</u>

When an organization does not have proper systems in place to detect embezzlement or theft by an officer or employee, the directors could be subject to liability for such acts by the officer or employee. For example, Allegheny Health, Education and Research Foundation (AHERF), the largest non-profit healthcare chain in Pennsylvania, filed for Chapter 11 to liquidate its assets, after it incurred approximately $1.4 billion in debt. This action was taken amid allegations (later proven) that management raided more than 350 charitable endowments to try and save the failing health care organization. The CEO pled no contest to criminal charges of stripping funds from charitable endowments and using them for purposes unrelated to the endowments, and was sentenced to a prison term of 23 months. Since the CEO didn't use the endowment funds for his own personal gain, the felony theft charges were dismissed.

d) <u>Dominant Executive Director (Founder's Syndrome)</u>

In addition to issues with taxes and unethical practices, another difficulty many nonprofits face is what is known as Dominant Executive Director/Founder's Syndrome. It often takes a passionate, dominate leader to initially get an organization past it's birth and early phases, however, this same type of autocratic approach can cause problems later on. A disproportionate amount of power in an impassioned individual or small group leading an NPO can lead to poor operational decisions due to a narrower scope of perspective than would be the case if decisions were made by a team of appointed professionals in various areas, as is the norm in the operations of any successful corporation, nonprofit or otherwise. This behavior can cause harm to the organization by limiting growth and creativity, lowering employee morale, and creating factions amongst executives among other issues. Fortunately, some organizations are able to recognize this tendency amongst founders and move past them.

e) <u>Conflicts of Interest/Self-Dealing</u>

Self-dealing, a form of conflict of interest occurs when a director or executive of an organization (or "disqualified person") uses their position to benefit themselves instead of furthering the organization's exempt purpose. According to 26 US Code §4941, self-dealing activities include, "(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or other extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and (F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946 (c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period." Any "disqualified person" found to be involved with an act of self-dealing will have an excise tax of 10% of the amount involved imposed on them by the IRS.

Under the Model Nonprofit Corporation Act and the Revised Model Nonprofit Corporation Act, a conflict of interest transaction may be approved by the directors, as provided in the specific Acts.

1. <u>Model Nonprofit Corporation Act</u>

i. <u>§ 8.60 CONFLICTING INTEREST TRANSACTIONS; VOIDABILITY</u>

"(a) **A contract or transaction between a nonprofit corporation and one or more of its members, director**s, members of a designated body, or officers or between a nonprofit corporation and any other entity in which one or more of its directors, members of a designated body, or officers are directors or officers, hold a similar position, or have a financial interest, **<u>is not void or voidable solely for that reason</u>**, or solely because the member, director, member of a designated body, or officer is present at or participates in the meeting of the board of directors that authorizes the contract or transaction, or solely because his or their votes are counted for that purpose, ***<u>if</u>***:

(1) the material facts as to the relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors and the board in good faith authorizes the contract or transaction by the affirmative votes of a

majority of the disinterested directors even though the disinterested directors are less than a quorum;

(2) the material facts as to the relationship or interest of the member, director, or officer and as to the contract or transaction are disclosed or are known to the members entitled to vote thereon, if any, and the contract or transaction is specifically approved in good faith by vote of those members; or

(3) the contract or transaction is fair as to the corporation as of the time it is authorized, approved, or ratified by the board of directors or the members.

"(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board that authorizes a contract or transaction specified in subsection (a).

"(c) This section is applicable except as otherwise restricted in the articles of incorporation or bylaws." (Emphasis added)

2. <u>Revised Model Nonprofit Corporation Act</u>

i. <u>§ **8.31. Director Conflict of Interest.**</u>

"(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A **conflict of interest transaction <u>is not voidable</u> or <u>the basis for imposing liability on the director</u> <u>*if*</u> the transaction was fair at the time it was entered into or is approved as provided in subsections (b) or (c)**.

"(b) transaction in which a director of a public benefit or religious corporation has a conflict of interest may be approved:

(1) in advance by the vote of the board of directors or a committee of the board if: (i) the material facts of the transaction and the director's interest are disclosed or known to the board or committee of the board; and (ii) the directors approving the transaction in good faith reasonably believe that the transaction is fair to the corporation; or

(2) before or after it is consummated by obtaining approval of the: (i) attorney general; or (ii) [describe or name] court in an action in which the attorney general is joined as a party; or

"(c) A transaction in which a director of a mutual benefit corporation has a conflict of interest may be approved if; (1) the material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board and the board or committee of the board authorized, approved, or ratified the transaction; or (2) the material facts of the transaction and the director's interest were disclosed or known to the members and they authorized, approved, or ratified the transaction.

"(d) For purposes of this section, a director of the corporation has an indirect interest in a transaction if (1) another entity in which the director has a material interest or in which the director is a general partner is a party to the transaction or (2) another entity of which the director is a director, officer, or trustee is a party to the transaction.

"(e) For purposes of subsections (b) and (c) a conflict of interest transaction is authorized, approved, or ratified, if it receives the affirmative vote of a majority of the directors on the board or on the committee, who have no direct or indirect interest in the transaction, but a transaction may not be authorized, approved, or ratified under this section by a single director. If a majority of the directors on the board who have no direct or indirect interest in the transaction vote to authorize, approve, or ratify the transaction, a quorum is present for the purpose of taking action under this section. The presence of, or a vote cast by, a director with a direct or indirect interest in the transaction does not affect the validity of any action taken under subsections (b)(1) or (c)(1) if the transaction is otherwise approved as provided in subsection (b) or (c).

"(f) For purposes of subsection (c)(2), a conflict of interest transaction is authorized, approved, or ratified by the members if it receives a majority of the votes entitled to be counted under this subsection. Votes cast by or voted under the control of a director who has a direct or indirect interest in the transaction, and votes cast by or voted under the control of an entity described in subsection (d)(1), may not be counted in a vote of members to determine whether to authorize, approve, or ratify a conflict of interest transaction under subsection (c)(2). The vote of these members, however, is counted in determining whether the transaction is approved under other sections of this Act. A majority of the voting power, whether or not present, that are entitled to be counted in a vote on the transaction under this subsection constitutes a quorum for the purpose of taking action under this section.

"(g) The articles, bylaws, or a resolution of the board may impose additional requirements on conflict of interest transactions." (Emphasis added)

f) <u>Resigning from a board</u>

Directors and officers may, generally, resign at any time without incurring any liability or breaching their fiduciary duties. They can resign for any reason or no reason at all, so long as they follow the organization's rules about resignations, including providing adequate notice. The Model Nonprofit Corporation Act and the Revised Model Nonprofit Corporation Act provide methods for directors to resign from their position.

1. **<u>Model Nonprofit Corporation Act</u>**

i. **<u>§ 8.07. Resignation of Directors</u>**

"(a) A director may resign at any time by delivering a signed notice in the form of a record to the chair of the board of directors or to an executive officer or the secretary of the corporation.

"(b) A resignation is effective when the notice is delivered unless the notice specifies a later effective time."

2. **<u>Revised Model Nonprofit Corporation Act</u>**

i. **<u>§ 8.07. Resignation of Directors.</u>**

"(a) A director may resign at any time by delivering written notice to the board of directors, its presiding officer or to the president or secretary.

"(b) A resignation is effective when the notice is effective unless the notice specifies a later effective date. If a resignation is made effective at a later date, the board may fill the pending vacancy before the effective date if the board provides that the successor does not take office until the effective date."

While a director is free to resign by following the corporate procedure for such resignation, a director should not resign if the interests of the organization would be left without proper care and protection at the time of such director's resignation. If a director resigns at a time when the corporation is having financial or governance issues the resigning director may be held liable for breach of fiduciary duty. See, *Purda Coal Stockholders Litigation, CA No 6476-CS. Del 2-6-13; and Rich v. Chong, 2013 Del. Ch. LEXIS 165 CA No 7616-VCG, DEL 7-2-13 (Del. Ch. Jul. 2, 2013)*

g) <u>Solvent</u>

What is a solvent corporation?

Generally, a corporation is solvent if it has sufficient working capital to continue operations. Specifically, solvency means a corporation has more assets than liabilities. When a corporation is solvent, the directors owe the fiduciary duties to the corporation and its shareholders, and generally, do not owe a fiduciary duty to the corporation's creditors. *In re Doctors Hosp. of Hyde Park, Inc., 474 F.3d 421, 428 (7th Cir. Ill. 2007)* and *In Re: Gulf Fleet Holdings, Inc. 2014 Bankr. LEXIS 2142*42-3*

A determination of solvency requires a factual review of the borrowers' financial condition and the application of complex and sometimes conflicting accounting practices and valuation theories. Although the definition of solvency on the surface appears simple, the factual finding of its existence may present difficulties which should be resolved by the trial court. *Mellon Bank, N.A. v. Aetna Business Credit, Inc., 619 F.2d 1001, 1014 (3rd Cir. 1980)*

For purposes of bankruptcy, the Bankruptcy Act utilizes a "balance sheet" test to determine solvency or insolvency, i.e., a corporation's assets, fairly valued, are to be compared to its debts as of the relevant date. *Allegaert v. Chemical Bank, 418 F. Supp. 690 (E.D.N.Y. 1976)*

h) Zone/Vicinity of Insolvency

While courts have not recognized a precise definition for "zone of insolvency", the topic has been discussed by several courts and is a topic for current and future litigation.

In Credit Lyonnais Bank Nederland v. Pathe Communications, C.A. No. 12150 (Del. Ch. Dec. 30, 1991) the Court of Chancery emphasized that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."

"The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors." "Directors must not think they owe duties directly to shareholders only. Directors who are capable of conceiving of the corporation as a legal and economic entity will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act." Id. at 108

In Geyer v. Ingersoll Publications Co., C.A. No. 12406 (De. Ch. June 18, 1992) the court stated that fiduciary duties to creditors arise when one is able to establish the fact of insolvency. The court also held that fiduciary duties arise at the moment of insolvency, rather than upon the initiation of statutory proceedings, noting that:

> "The existence of fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors' only concern. Furthermore, the existence of the duties at the moment of insolvency rather than the institution of statutory proceedings prevents creditors from having to prophesy when directors are entering into

> transactions that would render the entity insolvent and improperly prejudice creditors' interest."

In Delaware, creditors of a corporation in the "zone of insolvency" may not assert direct claims for breach of fiduciary duty against its directors; the Court does not attempt to set forth a precise definition of what constitutes the "zone of insolvency." *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 2006 Del. Ch. LEXIS 164*

1. Direct Claim v. Derivative Suit

"Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.

"Accordingly, we hold that individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation or any *other* direct nonfiduciary claim, as discussed earlier in this opinion that may be available for individual creditors.

"The creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors." *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla 930 A.2d 92 (Del. 2007)*

i) Insolvency

As noted above, the officers and directors of a NPO are charged with the fiduciary obligation to act in furtherance of the organization's charitable mission. A nonprofit corporation's director's duty of loyalty during the period of insolvency becomes one of pursuing or ensuring pursuit of the charitable purpose, goal and mission of the corporation. Directors are to ensure that a corporation's resources are used to achieve the corporation's purposes and not to enrich the directors, and must be principally concerned about the effective performance of the nonprofit's purpose, goal and mission. *Summers v. Cherokee Children & Family Servs., 112 S.W.3d 486 (Tenn. Ct. App. 2002)* “Any action that poses a palpable and identifiable threat to those goals, or that jeopardizes its assets would be contrary to the Certificate of Incorporation and hence *ultra vires*." *Oberly v. Kirby, 592 A.2d 445, 462 (Del. 1991)*.

If the directors do not adhere to the charitable purpose, goal and mission of the corporation, then the directors could expose themselves to liability for violating the nonprofit’s organizational documents. When directors do not adhere to the corporate mission, the directors breach their fiduciary duties by acting contrary to the corporation’s charter and bylaws. *Hegy v. Cmty. Counseling Ctr. of Fox Valley*, 158 F. Supp. 2d 892, 897 (N.D. Ill. 2001); and *State ex rel. Butterworth v. Anclote Manor Hosp., Inc.*, 566 So.2d 296, 298-99 (Fla. App. 2 Dist. 1990)

Courts have held that directors’ of for-profit corporations have a fiduciary duty to creditors upon insolvency; however, it is generally limited to protecting the contractual and priority rights of creditors. Bankruptcy courts have held that for-profit directors may be considered to have breached their fiduciary duties during insolvency when they approve transactions that maximize shareholder value to the detriment of creditors. When a corporation is insolvent the fiduciary duties owed to the corporation reorientate toward creditors, and thus, the officers and directors duties are to be exercised for the benefit of that corporation's creditors "because the creditors are now the residual claimants" of the corporation. Allegations of insolvency, therefore, can support a fiduciary duty claim based on actions that allegedly harm corporate creditors when the corporation is insolvent even though the actions may have benefitted the corporation's owner. However, while insolvent; fiduciary duties are not owed directly to creditors. Rather, the duty is owed to the corporation and requires directors and officers to maximize the value of the corporation for the benefit of creditors. *In Re: Gulf Fleet Holdings, Inc. 2014 Bankr. LEXIS 2142*

Creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand existing fiduciary duties.

While the same principles of law governing for profit corporations generally govern the activities of nonprofit corporations, as noted above in Section II, applying a director’s duty of loyalty to a for-profit corporation for decisions made during the period of insolvency to a nonprofit corporation would be contrary to advancing the NPOs charitable goals and most likely its governing documents.

When an NPO becomes insolvent, a court may take the NPOs charitable purpose/mission into consideration. The New Jersey District Court in *United Healthcare Systems* stated: "When analyzing an articulated business reason for the sale, the <u>bankruptcy court must also take into consideration the fact that a **debtor is a charitable institution**</u>." (Emphasis added) *In re United Healthcare System, Inc., 1997 U.S. Dist. LEXIS 5090, at *15 (D. N.J. Mar. 26, 1997).* The Court based its language upon *In the Matter of Brethren Care of South Bend, Inc., 98 Bankr. 927, 934-35 (N.D. Ind. 1989)* in which the court stated, "The well-being of the residents of the St. Paul's facility is of particular concern to the court. … Continuing satisfaction and ongoing beneficial treatment of the residents of the St. Paul's [retirement and nursing] facility is a good business reason for the sale of [its] assets as scheduled."

The Court in *United Healthcare Systems* noted that the law allows the bankruptcy court to entertain higher and better offers, which means that the bankruptcy court may not focus solely on price. See I*n re After Six Inc., 154 Bankr. 876, 882 (E.D. Pa. 1993)* (acknowledging that a lower bid may be better when other factors are involved, including "societal needs"). "Thus, in viewing that totality of circumstances, this Court cannot mechanically apply bankruptcy principles of "highest and best" offer. Rather, the Court must not only weigh the financial aspects of the transaction but also look to the countervailing consideration of a public health emergency." "Here, the sound business reason for the transaction was the need to sell a bankrupt hospital **<u>to ensure attendance to critical public health needs</u>**." (Emphasis added) Id. at 15-17

1) <u>Determining a Corporations Solvency/Insolvency</u>

Courts have several methods of analyzing a corporation's solvency that must be utilized. Commercial law recognizes several different insolvency concepts. Insolvency may be determined differently pursuant to 1) the federal bankruptcy code, *11 U.S.C. § 101(32)(A)*; 2) the Uniform Commercial Code, U.C.C. § 1-201(23); 3) the bankruptcy Insolvency test; or 4) the equity Insolvency test.

a) <u>Statutory Definitions</u>

11 U.S.C. § 101(32)(A) The term "insolvent" means - (A) with reference to an entity other than a partnership and a municipality, financial condition such that **the sum of such <u>entity's debts is greater than</u> all of such entity's property, at a fair valuation**, exclusive of- (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of this title [11 USCS § 522]; (Emphasis added)

U.C.C. § 1-201(23) "Insolvent" means: (A) having generally ceased to pay debts in the ordinary course of business other than as a result of bona fide dispute; (B) being unable to pay debts as they become due; or (C) being insolvent within the meaning of federal bankruptcy law.

b) **Bankruptcy Insolvency Test**

Under the bankruptcy Insolvency test, an entity is insolvent at a moment in time, if, at that moment, that entity's liabilities are greater than its assets. The bankruptcy test focuses on the balance sheet of a company at certain intervals of time in order to determine whether the company's liabilities are in excess of reasonable market value of its assets. This test is typically used for companies in serious financial difficulty with no reasonable prospect that the business can successfully be continued. *Kreps v. Commissioner, 351 F.2d 1 (2nd Cir 1965);*

Under the Bankruptcy Act, the definition of insolvency is based upon whether Debtor's assets were insufficient to pay its debts, not upon whether it was able to meet its debts as they came due. In determining whether transfers are voidable, the courts look to this balance sheet solvency/insolvency test - whether the assets outweigh the liabilities. *Laker v. Vallette, 1993 U.S. Dist. LEXIS 4560 (E.D.L.A 1993)*

c) **Equity Insolvency Test**

Under the equity Insolvency test, an entity is insolvent if it is unable to pay its maturing obligations as they become due in the ordinary course of business. This test equates insolvency with a lack of liquid funds, or the inability of a corporation to pay its debts in the ordinary course of business as the debts mature. It normally has the lower threshold of compliance, and may be used for companies in temporary financial difficulty which are not on the verge of failure. *Vestron, Inc. v. National Geographic Soc., 750 F. Supp. 586 (S.D.N.Y. 1990)*

Ultimately, in determining the insolvency of a corporation a court must include all the assets and liabilities of the corporation when applying both tests for insolvency. The notion of insolvency is measured both by a balance sheet showing all assets and liabilities and the test of whether one can meet current debts as persons engaged in a trade normally do. *Mellon Bank, N.A. v. Aetna Business Credit, Inc., 619 F.2d 1001, 1014 (3rd Cir. 1980)*

j) Deepening Insolvency

The liability of directors for deepening the insolvency of a corporation is a matter of debate at this time. The theory of deepening insolvency has been defined as prolonging an insolvent corporation's life through bad debt, causing the dissipation of corporate assets. *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 350 (3d Cir. 2001)*. This theory is an independent tort used by creditors as an attempt to recover from officers, directors, or outside professionals for causing a corporation to become more insolvent than it would have been if the officers, directors, or outside professionals had taken different actions or inactions.

In most cases, Federal Courts have made the determination that a state's highest court is likely or not likely to approve the theory, and a few states have addressed the issue. A deepening insolvency theory has been criticized and rejected by many courts, including Delaware, Minnesota, Oklahoma, Ohio, and Utah which have declined to recognize deepening insolvency as a form of corporate damages. The Fifth Circuit Court of Appeals, in *SI Restructuring, Inc. v. Faulkner (In re SI Restructuring, Inc.), 532 F.3d 355, (5th Cir. 2008)* concluded that deepening insolvency is not a valid theory of damages. The Court recognized that "deepening insolvency as a measure of harm depends on how the company uses the proceeds of the loan in question and 'looks at the issue through hindsight bias.'"

In Delaware, the courts have made it clear that deepening insolvency is not an independent tort. The Delaware Supreme Court issued an opinion in *Trenwick America Litigation Trust v. Billett, 2007 Del. LEXIS 357 (Del. Aug. 14, 2007,)* where it stated that "the final judgment of the Court of Chancery should be affirmed on the basis of and for the reasons assigned by the Court of Chancery in its opinion dated August 10, 2006."

The Delaware Chancery Court addressed the issue of deepening insolvency in great detail in *Trenwick America Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006)* In *Trenwick* the Court considered the doctrine of deepening insolvency as an independent cause of action or as a theory of damages and rejected the theory. As noted in *Trenwick* the Court,

> "Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept. Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, **the directors do not become a guarantor**

> **<u>of success</u>**. Put simply, under Delaware law, "Deepening Insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent.

Some Federal Courts have recognized “deepening insolvency” as a cognizable injury to corporate debtors. Those courts have applied the laws of Illinois, Louisiana and New York to uphold the theory.

In Pennsylvania, the Federal Courts have addresses the "deepening insolvency" theory, and have recognized the theory in cases of fraudulent concealment. In *Official Comm. of Unsecured Creditors v. R. F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001),* the Court addressed the question of whether "deepening insolvency" is a valid theory giving rise to a cognizable injury under Pennsylvania state law. The Court concluded that “’deepening insolvency’ constitutes a valid cause of action under Pennsylvania state law…” The Court believes the theory is sound, and stated that “[e]ven when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways. For example, to the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative costs on the corporation.

The Court noted that direct and indirect operational limitations may hurt a corporation’s ability to run its business in a profitable manner, when additional debt pushes the corporation into bankruptcy. Operational limitations due to the deepening insolvency may include, undermining a corporation's relationships with its customers, suppliers, and employees. “The very threat of bankruptcy, brought about through fraudulent debt, can shake the confidence of parties dealing with the corporation, calling into question its ability to perform, thereby damaging the corporation's assets, the value of which often depends on the performance of other parties.”

The decision in *Lafferty* has most recently been upheld in *Lemington Home for the Aged v. Baldwin (In re Lemington Home for the Aged), 659 F.3d 282; 2011 U.S. App. LEXIS 19312; 55 Bankr. Ct. Dec. 122 (3d Cir. Pa., Sept. 21, 2011)*, in which the court stated, “[a]s Appellees have noted in their brief, courts and commentators have increasingly called into question the viability of "deepening insolvency" as an independent cause of action. Even if our precedent is erroneous, however, it can only be overturned by this Court *en banc*. Consequently, we are bound in our decision to follow *Lafferty*, which recognizes deepening insolvency as an independent cause of action in Pennsylvania.” The Court concluded that for such a claim to succeed, the plaintiff must demonstrate that the directors' actions caused the deepening of insolvency, and that such deepening insolvency was the created through fraud on the part of the directors. "[A] claim of negligence cannot sustain a deepening-insolvency cause of action."

III. Defenses to Potential Liability

a) Business Judgment Rule

The "business judgment rule" traditionally applies to business corporations, but it is also the standard under which decisions of the officers and directors of any nonprofit corporation board. *America v. Yamartino, 2012 Me. Super. LEXIS 19 (Me. Super. Ct., Mar. 19, 2012).* The business judgment rule provides a level of protection for directors and officers from liability who act in good faith, and in a prudent, diligent and informed manner, make decisions or actions that may later prove to be unwise.

The Court in *America* noted that because most officers and directors of NPOs are usually volunteers, they should be afforded at least the same protection that is afforded to directors of for-profit corporations, if not more protection.

In order for a director to be covered by the business judgment rule, directors must adequately deliberate, act with reasonable diligence, and be informed before making material decisions, i.e. “the board must do more than rubber stamp the decisions of the active managers.” *Hill v. State Farm Mutual Automobile Ins. Co., 166 Cal. App. 4th 1438 (Cal. App. 2d Dist., Sept. 19, 2008)*

As part of the deliberation process, directors must review, question, and discuss the active manager’s recommendations before voting on them. In fact, "directors may rely on the management decisions and recommendations of officers", and often times will “have to rely on memoranda, documents, and oral statements prepared and presented by *other persons*. ‘Other persons’ includes directors, officers, and employees. … In the usual case, directors and officers will be reasonable in believing that they can rely on [the] information, opinions, reports, statements, decisions, judgments, and performance [of others] without the need for independent verification or further inquiry." See *Hill*

In determining reasonable diligence, a court considers factors such as a lack of conflicts of interest, independence, adequate investigation prior to the decision, and reliance upon outside experts. For example, in *Lemington Home for the Aged v. Baldwin (In re Lemington Home for the Aged), 659 F.3d 282; 2011 U.S. App. LEXIS 19312; 55 Bankr. Ct. Dec. 122 (3d Cir. Pa., Sept. 21, 2011)*, the Court noted that, "underlying the [business judgment] rule is the assumption that reasonable diligence has been used in reaching the decision which the rule is invoked to justify." Reasonable diligence may be proven by showing that a board when making a decision was 1) within the scope of the directors' authority, 2) disinterested, 3) assisted by counsel, 4) independent, 5) conducted an adequate investigation, and 6) whether it prepared a written report and 7) rationally believed its decision was in the best interests of the corporation at the time the decision was made

The informed decision prerequisite ... focuses on the preparedness of a director or officer in making a business decision as opposed to the quality of the decision itself. Reliance on reports, representations, statements, and opinions prepared by officers and employees of the corporation and by outside professionals and experts will often be necessary and will, in many situations, satisfy the informational requirement ... ." (Emphasis added) *Hill* quoting 1 ALI, Principles of Corporate Governance: Analysis and Recommendations, supra, § 4.01(c), com. e, pp. 177-178.

The business judgment rule does not apply where directors commit fraud, are self-dealing, seeking personal profit, commit wanton acts of omission or commission, act in a imprudent, wasteful, or careless manner, "lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available", and such actions have resulted in corporate losses. *Armenian Assembly of Am., Inc. v. Cafesjian, 772 F. Supp. 2d 20 (D.D.C. 2011)*

Courts are limited in what they may determine in a case involving the defense using the business judgment rule. *In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 970 (Del. Ch. 1996),* the Court stated "[w]hat should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with **a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed**. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests. To employ a different rule -- one that permitted an "objective" evaluation of the decision -- would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions." (Emphasis added)

The Model Nonprofit Corporation Act and the Revised Model Nonprofit Corporation Act provide language that will protect the directors and officers if they comply with the standards and actions set forth in the Acts.

b) <u>Model Nonprofit Corporation Act</u>

1. <u>§ 8.30(d)-(g). Standards Of Conduct For Directors</u>

"(d) In discharging board or committee duties a director who does not have knowledge that makes reliance unwarranted may rely on the performance by any of the persons specified in subsection (f)(1), (3), or (4) to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law.

"(e) In discharging board or committee duties, a director who does not have knowledge that makes reliance unwarranted may rely on information, opinions, reports, or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (f).

" (f) A director may rely, in accordance with subsection (d) or (e), on:

(1) one or more officers, employees, or volunteers of the nonprofit corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports, or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters: (i) within the particular person's professional or expert competence, or (ii) as to which the particular person merits confidence;

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence; or

(4) in the case of a corporation engaged in religious activity, religious authorities and ministers, priests, rabbis, imams, or other persons whose positions or duties the director reasonably believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented.

"(g) A director is not a trustee with respect to the nonprofit corporation or with respect to any property held or administered by the corporation, including property that may be subject to restrictions imposed by the donor or transferor of the property."

2. <u>§ 8.42(c). Standards Of Conduct For Officers</u>

"(c) In discharging his or her duties, an officer who does not have knowledge that makes reliance unwarranted may rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the nonprofit corporation whom the officer reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports, or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the officer reasonably believes are matters: (i) within the particular person's professional or expert competence, or (ii) as to which the particular person merits confidence;

(3) in the case of a corporation engaged in religious activity, religious authorities and ministers, priests, rabbis, imams, or other persons whose positions or duties the officer reasonably believes justify reliance and confidence and whom the officer believes to be reliable and competent in the matters presented."

3. <u>§ 8.31 STANDARDS OF LIABILITY FOR DIRECTORS</u>

"(a) <u>A director is not liable</u> to the nonprofit corporation or its members for any decision to take or not to take action, or any failure to take any action, as a director, <u>unless</u> the party asserting liability in a proceeding establishes that:

(1) none of the following, if interposed as a bar to the proceeding by the director, precludes liability:

(i) subsection (d) or a provision in the articles of incorporation authorized by Section 2.02(c);

(ii) satisfaction of the requirements in Section 8.60 for validating a conflicting interest transaction; or

(iii) satisfaction of the requirements in Section 8.70 for disclaiming a business opportunity; and

(2) the challenged conduct consisted or was the result of:

(i) action not in good faith; or

(ii) a decision:

(A) which the director did not reasonably believe to be in the best interests of the corporation, or

(B) as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances; or

(iii) a lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence due to the director's domination or control by, another person having a material interest in the challenged conduct:

(A) which relationship or which domination or control could reasonably be expected to have affected the director's judgment respecting the challenged conduct in a manner adverse to the corporation, and

(B) after a reasonable expectation to such effect has been established, the director has not established that the challenged conduct was reasonably believed by the director to be in the best interests of the corporation; or

(iv) a sustained failure of the director to devote attention to ongoing oversight of the activities and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefor; or

(v) receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its members that is actionable under applicable law.

"(b) The party seeking to hold the director liable:

(1) for money damages, also has the burden of establishing that:

(i) harm to the nonprofit corporation or its members has been suffered, and

(ii) the harm suffered was proximately caused by the director's challenged conduct; or

(2) for other money payment under a legal remedy, such as compensation for the unauthorized use of corporate assets, also has whatever persuasion burden may be called for to establish that the payment sought is appropriate in the circumstances; or

(3) for other money payment under an equitable remedy, such as profit recovery by or disgorgement to the corporation, also has whatever persuasion burden may be called for to establish that the equitable remedy sought is appropriate in the circumstances.

"(c) Nothing contained in this section:

(1) in any instance where fairness is at issue, such as consideration of the fairness of a transaction to the nonprofit corporation under Section 8.60(a)(3), alters the burden of proving the fact or lack of fairness otherwise applicable,

(2) alters the fact or lack of liability of a director under another section of this [act], such as the provisions governing the consequences of an unlawful distribution under Section 8.33, a conflicting interest transaction under Section 8.60, or taking advantage of a business opportunity under Section 8.70; or

(3) affects any rights to which the corporation or a director or member may be entitled under another statute of this state or the United States.

"(d) Notwithstanding any other provision of this section, a director of a charitable corporation shall not be liable to the corporation or its members for money damages for any action taken, or any failure to take any action, as a director, except liability for:

(1) the amount of a financial benefit received by the director to which the director is not entitled;

(2) an intentional infliction of harm;

(3) a violation of Section 8.33; or

(4) an intentional violation of criminal law" (Emphasis added)

c) <u>Revised Model Nonprofit Corporation Act</u>

1. <u>§ 8.30(b)-(e). General Standards for Directors.</u>

"(b) In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence;

(3) a committee of the board of which the director is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence; or

(4) in the case of religious corporations, religious authorities and ministers, priests, rabbis or other persons whose position or duties in the religious organization the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented.

"(c) A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

"(d) A director is not liable to the corporation, any member, or any other person for any action taken or not taken as a director, if the director acted in compliance with this section.

"(e) A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property."

2. <u>§8.42(b-(d)). Standards of Conduct for Officers</u>.

"(b) In discharging his or her duties an officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation who the officer reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants or other persons as to matters the officer reasonably believes are within the person's professional or expert competence; or

(3) in the case of religious corporations, religious authorities and ministers, priests, rabbis or other persons whose position or duties in the religious organization the officer believes justify reliance and confidence and who the officer believes to be reliable and competent in the matters presented.

"(c) An officer is not acting in good faith if the officer has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

"(d) An officer is not liable to the corporation, any member, or other person for any action taken or not taken as an officer, if the officer acted in compliance with this section."