

Board Governance and the Non-Profit Organization

What is the Fiduciary Duty of a Board Member?

A board member in a non-profit organization has broad management authority as it relates to policies and procedures which include finance, strategic development and oversight. Fulfilling this responsibility begins with understanding the nature and scope of the duty which is comprised of the duty of care, duty of loyalty and duty of obedience. "Best practice" for all non-profits should include a clear understanding of company procedures and its bylaws as well as establishing procedures by which compliance with the fiduciary duty is ensured.

1. The Duty of Care

The *duty of care* requires that a director discharge his or her duty: (i) in good faith; (ii) with the care an ordinarily prudent person in a like position would exercise; and (iii) with a reasonable belief the action to be taken is in best interests of the organization. R.I.G.L. § 7-6-22.

1. *Good Faith* - The good faith requirement demands honesty, fair dealing and is measured by reviewing objective facts and circumstances.

2. *Ordinary Prudence/Due Diligence* - Ordinary prudence means that directors need act only with "common sense and informed judgment" and does not require special skills to perform board duties. On the other hand, "diligence" requires that a director take an active interest in the organization's activities which would necessarily involve a proactive approach with oversight responsibility. Simply "rubber stamping" the recommendations made by management does not satisfy this requirement.

3. *Best Interests of the Organization* - A Board member must constantly ask, "is the decision made in the best interests of the organization or of an individual."

It is permissible for a director of a non-profit organization to rely upon the expertise of management and/or outside consultants; however, prudent care requires reasonable inquiry and for the director to be well informed when considering opinions of others. R.I.G.L. § 7-6-22. Those who may be relied upon in providing expertise and recommendations include officers or employees whom the director reasonably believes to be reliable and competent in the matters presented. Legal counsel, accountants or outside consultants provided that the director reasonably believes that each party is competent to provide the guidance required for a board member to make a decision.

Board members are afforded some protections as the result of volunteer protection statutes and the "business judgment rule."¹ How does the business judgment rule apply to board decisions? This rule has evolved through common law decisions reviewing judgments by members of boards. Prior to the public scandals of Enron and WorldCom, courts generally found that a board decision is presumptively correct and will not be challenged. The reasoning behind this rule was that a board functions best when informed decisions are not disrupted by judicial scrutiny except in cases of egregious misconduct.

¹ Most states and the federal government have a variety of volunteer protection statutes which, while not wholly immunizing directors from civil liability, sharply reduce the scope of their exposure. In Rhode Island, this protection is provided in R.I.G.L. § 7-6-9.

As we will learn in later summaries, this general rule is under attack in recent court review of board decision making procedures.

Notwithstanding, this general proposition, if applied shields directors totally from liability for business decisions provided that a decision is not the result of gross negligence or a clear violation of the fiduciary duties. Lynch v. John W. Kennedy Co., 2005 WL 1530469 (R.I. Super.)

2. *The Duty of Loyalty*

The duty of loyalty requires that a director's conduct further the organization's goals and not their own interests. This fiduciary duty prohibits a director from using the director position or information concerning the organization in a manner that allows them to secure a personal pecuniary benefit. For example, the Rhode Island Non-Profit Corporations Act specifically prohibits loans to directors. RIGL § 7-6-32. In addition, in order for a conflict of interest to exist the conflict must involve a personal financial interest of a director or that of a director's family member or close associate. The Rhode Island non-profit law does not prohibit contracts or transactions between corporations and their directors provided that the relationship is fully disclosed. The requirements for disclosure are as follows:

1. Disclosure of the material facts of the conflicting interests;
2. Disclosure of the specific terms of the proposed contract or other transaction between the nonprofit organization and the conflicting entity;
3. The contract or transaction is fair and reasonable to the corporation;
4. The full board or committee reviewing the contract or transaction must approve it by a disinterested majority, although interested directors may generally be counted toward a quorum and may cast a non-decisive vote. In approving the transaction, a disinterested director must exercise normal "business judgment" and their "duty of care." RIGL § 7-6- 26.1.

The Internal Revenue Service sanctions apply to transactions between a nonprofit organization and a "disqualified person." The code defines a disqualified person as anyone who was in a position to exercise substantial influence over the affairs of the organization at any time during the five years preceding the transaction. This may include officers, directors, trustees, highly compensated and/or high level employees, department or project managers, major donors, vendors, and others. If the organization engages in a transaction in which it pays more than fair value for a product or service, such fact must be documented and justified in the organization's minutes. In order to protect the organization and its managers, all financial transactions between the organization and a disqualified person should be reviewed, documented, and approved by "disinterested members" of the board i.e., individuals who do not benefit from the transaction and whose family members have no stake in it either.

The fiduciary duty of a board member also includes the adoption of a thoughtful, carefully articulated conflict-of-interest policy. A conflict of interest policy should be tailored to the organization's mission statement and general business and include, at a minimum:

1. To whom the policy refers
2. Determinations regarding conflicts
3. Scope of the activities to be covered
4. How the policy will be enforced
5. Training programs for board members, management and staff
6. Subject the policy to review periods.

A successful conflict-of-interest policy begins with the organization conducting a thorough review of the activities and affiliations of its board members, officers and employees. A typical conflict-of-interest policy requires periodic circulation of surveys to identify actual or potential conflicts. The information disclosed in the course of this effort should be reviewed annually by independent counsel or a designated officer and the results reported to the full board or a committee, both for informational purposes and to prompt any

necessary action.

3. The Duty of Obedience

Compliance with law and regulations is the most significant duty of obedience in the non-profit world. The board member has an obligation to ensure that the organization acts in compliance with all laws generally affecting its business operation. Examples of this duty include withholding and employment tax requirements, tax laws and civil rights laws, non-discrimination laws, etc.

Structure of the Board and Management

1. Management Structure

For many years the Executive Director based management structure was considered the form most accepted and effective in managing the everyday affairs of a non-profit. Today, a CEO based management structure is much more suitable to effective management given the complexity and size of many non-profit organizations. The CEO form of management is designed to provide the board with the ability to focus on oversight in that the professional attributes of its managers are enhanced for daily operations. The typical structure has a CEO which reports directly to the board and who works through various board committees. Reporting to the CEO is the Chief Operating Officer, Chief Financial Officer, Human Resources Director, Director of Development, etc. This structure is replacing the all encompassing role of the former "Executive Director" in the larger non-profit organizations.

2. Right Sizing the Board

In recent surveys taken regarding size and functionality of a non-profit board it has been determined that the optimum board size is between ten (10) and fifteen (15) members. In many cases the non-profit may have a board that is larger than the ideal model for effective governance.² In order to ensure that boards are effective in governing the organization the effort of the consultant should be to reduce the size of the board and develop a committee organization

that delegates responsibility to those with the requisite expertise in the area of management. The restructure of the board will lead to honorary directors, emeritus directors, advisory boards, or councils and this development will improve governance and morale among the members of the organization.

3. Composition of the Board

Non-Profit organizations should consider implementing a nominating committee structure with strict guidelines and criteria for the nomination of new board members. The nominating committee develops the criteria and evaluates performance on a routine basis. This type of committee would also address the following issues:

1. The size of the board;
2. The composition of the board, ensuring that there are financial and other relevant experts and generally establishing the necessary qualifications and composition of each board position;
3. Management structure;
4. Nomination, orientation, and election of directors and officers;
5. Oversight of the corporate form and compliance with its necessities; and
6. Effectiveness and composition of other board committees.

Corporate Responsibility

1. Develop a Code of Ethics

All non-profits must adopt and periodically review a code of business conduct and ethics for directors, officers, and employees. At a minimum the code would address the following issues and/or policies:

1. Conflicts of interest
2. Corporate opportunity
3. Confidentiality of information
4. Fair dealing

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5. Preservation and prudent use of company assets
6. Compliance with laws, rules and regulations
7. Methods for reporting any illegal or unethical behavior

Each code should contain compliance standards and procedures to facilitate the effective operation of the code. Any waivers of the code should be clearly documented and disclosed if necessary.

2. Whistleblower Protection

Non-profit organizations should establish procedures for receiving, investigating and taking appropriate action regarding fraud or other compliance issues. "Whistleblowers" must be protected from retaliation or disciplinary action for reporting possible violations in good faith. The non-profit should provide several reporting mechanisms providing options that keep confidential the identity of the reporting person.

1. Hotline - A common and effective measure of monitoring compliance is an anonymous hotline. The organization can designate an officer to listen and report on the messages left on the hotline.
2. Up-the ladder - In addition, the non-profit should have a reporting process that clearly establishes the process by which potential violations may be reported.

The policy should specify an officer who has the responsibility of reviewing all complaints and if necessary reporting and taking appropriate action. Also, attorneys should be encouraged to report evidence of potential compliance problems to the audit committee, to another committee composed entirely of outside directors, or to the board of directors as a whole.

3. Mission Statement

The board has the ultimate responsibility of ensuring that the mission of the organization is achieved. Each board has the responsibility of evaluating and updating the mission statement for the organization. At a minimum, the board should undertake and document the following

steps on an annual basis:

1. Identify any possible deficiencies in the accomplishment of the mission.
2. A periodic general overview of the organizations performance as related to the mission.
3. Review the substance of the mission to determine whether change is necessary.

4. Financial Disclosure Requirements

Non-profit organizations are not required to comply with federal securities laws; however, "best practice" dictates that the organization should endeavor to be transparent and accountable to donors, clients, public officials, the media, and others with respect to its financial condition and business operation. Form 990 is the document that is filed by non- profits and this form will be made available to anyone requesting it by following the procedures required. Although Form 990 does contain financial disclosures the comprehensiveness of the information is not at the same level as that required of public companies by the SEC. It is readily apparent; however, that non-profits will be made to improve the scope and meaningfulness of the disclosure in the years to follow.

Conclusion

Non-profit organizations should implement "best practices" with respect to their organizational structure and daily operations. The extent and scope of the practices adopted must be measured and consistent with the mission statement for the organization. The Sarbanes-Oxley Act of 2002 should be used as a guideline for "best practices" and the modern day board member must insist that the organization challenge itself to be transparent and accountable to donors, creditors and the public at all times.

Pannone Lopes and Devereaux is committed to providing Rhode Island non-profits with the guidance required to modernize the daily operations and governance practices demanded by federal and state law as well as the regulatory agencies in general.

This outline is not a complete analysis and may not be relied upon as legal advice. Please contact Gary R. Pannone, Esquire for further consultation at 401-824-5115 or send an email to him at gpannone@pldw.com.