ARNOLD & PORTER LLP

Memorandum

From: **James P. Joseph**
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Re: **Fiduciary Duties of a Director and Conflicts of Interest**

The following is an overview of the duties of a member of a board of directors of a nonprofit corporation ("Corporation"), with particular emphasis on the financial management of the Corporation.

A director owes a fiduciary duty to the Corporation. In performing his or her duties, a director must act in the best interests of the Corporation (e.g., work to fulfill the Corporation's tax-exempt purposes and maintain its tax-exempt status). The director may not act in a way that is detrimental to the Corporation in an effort to benefit any third party. The director must disclose to the other members of the board of the Corporation when the board's actions may have a material impact on the director or another corporation or entity in which the director has a financial interest. The director must not participate in any board discussion or vote on such issues, unless the board determines that the director may so participate. If the board determines that the director may participate, the director may still decide that a conflict exists and that he or she should not participate in any discussion or vote.

I. General Duties That a Director Owes to the Corporation

The duties that a director owes the Corporation are the *duty of obedience,* the *duty of care* and the *duty of loyalty*. In general, under the "business judgment rule," if a board of directors properly exercises these duties, its members will be protected from liability for their actions on the board. In effect, there is a presumption that, in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interest of the Corporation. This presumption can be overcome with a showing that the board acted with gross negligence.

A. Duty of Obedience

- The directors of the Corporation must not engage in *ultra vires* acts – acts that the corporation, under its charter and applicable law, can not perform because such acts are prohibited or beyond the scope of the corporation's powers.

B. Duty of Care

- The duty of care generally describes the level of attention required of a director in all matters related to the Corporation. The duty of care is perhaps more accurately described as a "duty to be informed."

- A director has the responsibility to be informed about an issue before making a business decision relating to the issue.

  - A director will fulfill the duty of care if, prior to making a decision, he or she considers all material information reasonably available to him or her.

  - To fulfill the duty of care, the directors of a Corporation should follow deliberate procedures and consult with appropriate committees, officers, or employees of the Corporation or other outside experts in making corporate decisions.

C. Duty of Loyalty

- The duty of loyalty requires a director to act *solely* in the best interests of the Corporation rather than in his or her own interests, or those of his or her associates.

- One important aspect of the duty of loyalty is to retain the confidentiality of information that is explicitly deemed confidential by the Corporation, as well as information that appears to be confidential from its nature or matter.

- The duty of loyalty also encompasses a director's obligation to avoid conflicts of interest.

  - For a director, a violation of this duty may result in personal liability for a breach of fiduciary duty.

  - For the Corporation, such a breach may allow a court to void the corporate transaction in which a conflict was present.

II. Conflicts of Interest

- In general, a conflict of interest exists when the Corporation does business with:

  - a director of the Corporation;

  - another entity in which a director of the Corporation is also a trustee, director, officer, employee, consultant, or agent; or

- another entity in which a director has a financial interest (a “financial interest” can generally be defined to include an ownership or investment interest in the entity with which the Corporation is contracting, or a compensation arrangement with such entity).

- To avoid even the appearance of a conflict of interest, a director may want to treat as a conflict any transaction between the Corporation and (i) the director’s spouse, descendants, or ascendants, (ii) any entity in which such a relative is a trustee, director, officer, employee, consultant, or agent, or (iii) any entity in which such a relative has a financial interest.

- In addition, the Corporation may have its own conflict of interest policy that must be followed.

- If a conflict of interest is or may be present, the director must:

  - Disclose to the board of directors or relevant committee of the board the material facts as to his or her relationship or interest.

  - Not participate in any board discussion or vote, unless the Corporation’s board determines that the director may participate in such discussion or vote.

- If the board determines that the director may participate, the director may still decide that a conflict exists and that he or she should not participate in any discussion or vote.

- If a director follows these disclosure and recusal procedures, a party challenging a transaction on the grounds of a conflict of interest/breach of fiduciary duty will face a heightened burden.

II. The Duty of Care: Financial Management Obligations

In general, under the “business judgment rule,” if a board of directors properly exercises the fiduciary duties discussed above, its members will be protected from liability for their actions on the board. In effect, there is a presumption that, in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interest of the Corporation. This presumption can be overcome with a showing that the board acted with gross negligence. Despite the relatively significant burden of trying to prove gross negligence by a nonprofit director, and despite the protections of the business judgment rule, nonprofit directors can be held responsible when an organization’s finances are poorly managed.

A. General Mismanagement. This type of mismanagement is characterized by a pattern of actions or inactions that result in significant harm over a period of time. In one case, *Lynch* v. *John H. Redfield Foundation*, 88 Cal. Rptr. 86(Cal. Ct. App.1970), the directors of a foundation allowed the organization's income to accumulate in non-interest bearing accounts for over five years. This investment decision was made as a result of long-term disagreements among the directors that resulted in their inability to productively manage the foundation's assets. As stated by the court: "All three directors, in concentrating on their feud, left the foundation in a state of suspended animation for several years, ignoring their obligations to carry on its charitable purposes and to manage its assets with a degree of care and diligence which a prudent man would exercise in the management of his own affairs." *Id.* at 88. Although in the above case a feud was to blame for the financial mismanagement, more often such mismanagement is a result of neglect. More rarely, claims are made challenging the directors' decision-making. These claims often involve a single action, such as sale of an asset below value, and also often involve specific action by a board, rather than simply inattention.

B. General Neglect. The term "good faith" most obviously means an absence of any intent to take advantage of the corporation. It is largely a state of mind characterized by both "honesty" and "faithfulness to the director's duties and obligations." "Honesty" has been appropriately interpreted to mean "pureheartedness." "Faithfulness to the director's duties and obligations," however, is more than a mindset. It means some level of diligence in actually seeking to discharge the director's responsibilities. General neglect in decision-making, therefore, would not be good faith. In the leading case of *Stern et al.* v *Lucy Webb Hayes National Training School for Deaconesses and Missionaries, et al.*, 381 F. Supp. 1003 (D.D.C. 1974), the board of directors was found to have breached its fiduciary duty in part for allowing, through inaction and inattention, the reserve fund of the corporation to languish in investment vehicles that paid very low interest rates or no interest at all.

C. Bad Business Decisions. These type of claims are often characterized as a "waste of corporate assets." Because of the business judgment rule, discussed above, these claims are difficult to prove. In one case, *Mary* v. *The Lupin Foundation*, 609 So.2d 184 (La. 1992), a non-profit corporation sold its sole asset, a hospital, to a for-profit health care company for $17.5 million. A member of the non-profit board who objected to this sale sued his fellow board members, alleging that the market value of the hospital was as much as $5 million above the sale price, and that the sale below value was a breach of their fiduciary duty. This director further alleged

that the board never solicited other offers or made an attempt to value the hospital. The court held that these allegations, if true, would constitute a violation of the directors' fiduciary duty.

D. Mismanagement of Investments. The duty of care includes, and in fact mandates, that the board protect the assets of the Corporation. This includes the general management and investment of all of the Corporation's funds.

- A Reasonable Plan. A board is not an insurer of the adequate performance of a Corporation's funds in an investment vehicle, but investment decisions must be reasonable and defensible. The leading case in this area is *Johnson* v. *Johnson*. 516 A.2d 255 (N.J. Super. 1986). In this instance, the dispute involved the investment of funds owned by two charitable foundations. After a detailed review of various investment approaches, the court concluded that the individual in charge of investments had pursued a reasonable investment strategy. What is important about this case is that the defendant's investment approach was unsuccessful. Nonetheless, the court found that the defendant had pursued a reasonable course of action.

- Outside Advice. Directors are not expected, or legally required, to be experts in the stock market or other investment vehicles. Retention and reliance on an investment advisor with a good reputation is more than reasonable; it is an effective protection for the board, even if the advice given ultimately is flawed. For example, in one case, a court found that a nonprofit board's failed investment decisions did not violate its fiduciary duties where they were "based, in part, on research provided by the [organization's] analysts and conforming to guidelines set forth by various investment strategy groups composed of senior portfolio managers, who regularly monitored the suitability of equity investments and rate securities in various categories based upon performance." *In the Matter of Bankers Trust Company*, 636 N.Y.S.2d 741 (A.D.2d 1995).

- Oversight. In the vast majority of cases, nonprofit directors have incurred liability related to investments not because investments knowingly made simply underperformed, but rather, when the directors have delegated investment responsibility to an individual or committee, and then failed to oversee or supervise that person/entity. The leading case is *Stern* v. *Lucy Webb Hayes National Training School For Deaconesses & Missionaries*, discussed above, where the delegation of authority was permissible, but the board never sought or received a report as to the status or performance of the invested funds.

- Delegating or Abdicating Authority. While, as discussed above, it is not unusual for a nonprofit board to delegate investment responsibility (e.g., to a committee or individual director or staff member), boards should document such a delegation and be clear as to the scope of the delegation. A number of cases involving negligent investment liability arise out of the conduct of just one corporate officer or director who, through neglect or otherwise, is granted broad discretion which he or she ultimately abuses. In *Hoye* v. *Meek*, 795 F.2d 893 (10th Cir. 1986), the president of a company delegated investment responsibility to his son, also an employee of the company. While the son was subject to a board policy restricting investments to supposedly-safe government securities, he managed to make such investments in a very risky manner, with disastrous results. Although the President and other board members received monthly reports as to the finances of the organization, no action resulted from reviewing the reports that were provided. The court found the president liable for the losses.

- Uniform Act. Virtually all States have adopted the Uniform Management of Institutional Funds Act, which is generally applicable to directors of charitable corporations. This legislation essentially codifies a corporate standard of care for investment activity. A typical State statute provides as follows: In the administration of the powers to appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider long- and short-term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions. D.C. Code § 32-406.