Understanding the Unique Liabilities of Serving as a Director or Officer of a Nonprofit

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**TIP**

Don’t let your mission eclipse your margin! By ensuring that a nonprofit board routinely reviews the organization’s bylaws to verify compliance, directors and officers can significantly reduce exposure.

While serving as a director or officer of a nonprofit can be extremely rewarding, nonprofit directors and officers must also be mindful that their service could expose them to a wide range of risks. Understanding these potential risks is critical for the successful management of any nonprofit organization.

One aspect that makes nonprofits particularly susceptible to risk is their limited assets. Smaller budgets, fewer personnel, and lack of resources to consult outside professionals, such as accountants, financial advisors, or attorneys, can create the perfect storm for errors or omissions to occur. Another risk factor for any nonprofit is when board members and officers prioritize mission over margin. That is, their focus on the cause of the organization eclipses their attention to finances and managing the operations of the organization.

While many states have statutorily limited the liability of nonprofit directors and officers under certain circumstances, such protection may be conditioned on the director’s or officer’s compliance with a specified standard of conduct or may be subject to other delineated limitations. Moreover, under the supremacy clause of the United States Constitution, state statutes cannot eliminate directors’ and officers’ liability for violations of federal law. By adhering to certain conduct and adopting and enforcing adequate policies, however, the potential legal risks that nonprofit directors and officers may encounter can be reduced. This article provides an overview of the potential legal risks that nonprofit directors and officers may encounter as well as tips to reduce those risks.
Breach of Fiduciary Duty Claims
Directors and officers of nonprofits are charged with fiduciary duties to the organization. Because the duty is owed to the organization, the parties that have standing to bring a breach of fiduciary claim against a nonprofit are limited. Claims can be made by (1) other directors or officers or the organization itself; (2) state attorneys general; (3) parties that have a “special relationship” with the nonprofit; and (4) due to the tax-exempt nature of a nonprofit, the Internal Revenue Service (IRS).

Duties of Directors and Officers
Nonprofits are governed primarily by state law. Representative provisions defining fiduciary duties may be found in the Revised Model Nonprofit Corporation Act (2008) (MNCA), a draft statute prepared by the American Bar Association that serves as guideline legislation for states to enact in whole or in part. While a number of states have adopted some version of the MNCA, other states have adopted somewhat different legislation. There are, however, certain general uniform principles that govern the fiduciary duties of directors and officers of nonprofits.

Directors and officers of any nonprofit are charged with three main duties: (1) the duty of care, (2) the duty of loyalty, and (3) the duty of obedience. Directors and officers are required to adopt the “business judgment rule” in carrying out their duties. To exercise sound business judgment, the director or officer must:

a. be informed of the facts and make reasonable inquiries into the facts;

b. make judgments in good faith and without conflicts of interest, bias, or outside influence;

and

c. make reasonable judgments, founded on a sound, rational, and defensible basis, which are in the best interests of the corporation.

The business judgment rule creates a presumption that decisions are made based on sound business judgment, but may be rebutted by a factual showing of fraud, bad faith, or gross overreaching. In most circumstances, if a director adheres to these duties in carrying out the business of the organization, he or she generally will be able to raise the business judgment rule as a defense to liability. It is important to note, however, that the law as to whether the exculpatory protections of the business judgment rule apply to decisions made by non-director officers varies by state.

Duty of care. The duty of care requires directors and officers to act prudently and reasonably in discharging their duties in the management of the organization’s affairs. When discharging his or her duties, each director or officer must: (1) act in good faith, and (2) in a manner he or she reasonably believes to be in the best interests of the organization. The directors or officers must discharge their duties with the care that a person of like position would reasonably believe appropriate under similar circumstances. The duty of care also requires the director to be informed, be vigilant, and exercise independent judgment. This requires regularly attending board meetings and ensuring that proper financial and management controls are in place. It also requires officers to inform the board of material information known to the officer. While directors and officers are entitled to retain outside professionals, such as accountants, legal counsel, or financial advisors, the directors and officers must be diligent in their oversight of these professionals and assessing the information presented to them.
Directors and officers cannot merely ignore suspicious information provided to them by outside professionals. If information appears questionable or unreliable, the director or officer must exercise due diligence and make additional inquiries to ensure the validity of the information.

In determining whether a breach of the duty of care took place, courts will look at the totality of circumstances and will expect that directors and officers make decisions with the same degree of care that they would use in their own businesses or personal lives. Directors and officers are expected to exercise careful oversight, undertake conservative action, and engage in analysis of factual issues. If it can be established that directors or officers were grossly negligent in carrying out their duties, they may be held liable for the losses arising from their breach and/or may be subject to removal.

The most typical claims for breach of the duty of care as respect nonprofits tend to involve the management of finances. Financial mismanagement claims generally fall into several categories: (1) general mismanagement, (2) negligence, and (3) waste of corporate assets.

Claims of general mismanagement and negligence both usually involve alleged patterns of action or inaction that result in significant losses over a period of time. These claims can involve conduct such as leaving assets in investment vehicles that bear little or no interest, lack of oversight of third-party professionals, mishandling or misuse of endowment funds, lack of oversight of executive conduct and/or compensation, etc. The usual distinction in proving a claim for mismanagement as opposed to negligence is the director’s or officer’s state of mind. Claims for negligence generally involve circumstances where there is no evidence of any intent by the director or officer to take advantage of the organization.

Claims for waste of corporate assets are generally more difficult to prove due to the business judgment rule. Directors are not automatically liable just because an investment underperforms. Directors are generally protected from honest mistakes made in good faith if they: (1) exercised good faith judgment without carelessness or gross negligence; (2) acted within the powers granted to the organization by state law and the organization’s bylaws; (3) executed such judgment after due consideration of the relevant facts; and (4) acted in the organization’s best interests and without any conflict of interest.

A common example of a waste of corporate assets claim involves an asset sale where a director, member, or person with a special relationship to the organization claims that the sale of an asset was below value. In these circumstances, the opposition will commonly argue that the board never solicited other offers or made an attempt to value the asset in breach of its fiduciary duties.

**Duty of loyalty.** The duty of loyalty prohibits directors and officers from using their position in the organization to further their own personal interest. Directors are expected to disclose all relevant information in their possession or control with respect to any decision or question brought before the board. Claims for breach of the duty of loyalty generally arise from (1) conflicts of interest, (2) usurping a corporate opportunity, and (3) breaches of confidentiality of the organization’s information.
A conflict of interest arises when a director or officer has a direct or indirect personal interest in a transaction. A conflict can arise if the director or officer might have an interest or investment that might benefit from the transaction at issue. A conflict may also exist if a transaction might benefit a family member of a director or officer or if the proposed transaction involves the director’s employer.

Nonprofits are particularly susceptible to conflicts of interest insofar as their board members are often recruited based on business relationships or professional affiliations. The existence of a potential conflict, however, does not automatically prohibit a transaction. Instead, many states’ laws provide that if certain precautions are taken, the approval of such transaction does not constitute a breach of fiduciary duty. The director or officer must disclose the conflict to the board and refrain from participating in any deliberations and, in most cases, the vote on the transaction. Moreover, the board must be able to establish that the disinterested directors approved the transaction in good faith and reasonably believed it was fair to the organization.

The duty of loyalty also prohibits directors and officers from usurping corporate opportunities and competing with the organization. The corporate opportunity doctrine applies to any opportunity that the director or officer should reasonably know would be of interest to the organization, whether or not the individual learned of it by virtue of his or her position with the organization. When presented with such an opportunity, most states require the director or officer to first present the opportunity to the organization’s board. The individual should only take advantage of the opportunity after the board has declined the opportunity.

Directors and officers are also required to protect the confidentiality of the organization’s information. A director or officer should not only preserve the confidentiality of information that is expressly designated confidential by the organization, but also information that appears to be confidential based on its nature or matter. This includes information regarding pending claims or litigation or employees’ personal information.

**Duty of obedience.** The duty of obedience requires directors and officers to ensure that the organization is run in accordance with its charter and bylaws, and that the organization complies with applicable laws. Therefore, a director must understand the bylaws and state law, attend meetings, be informed of the facts, and disclose any personal bias or interest or information unknown to the other directors.

One of the most crucial responsibilities of a director is to ensure that the nonprofit is adhering to the mission for which it was established. When the organization is not carrying out its mission, it may be susceptible to claims by the state attorney general who, in many states, is empowered to enforce compliance with the organization’s mission.

**Government Investigations and Lawsuits**
Other government officials, including representatives of the IRS and the U.S. Department of Labor, as well as state attorneys general, may bring actions against nonprofit directors and officers alleging violations of state or federal laws. In order to retain nonprofit status, nonprofit organizations are required to routinely file financial information and register with the state. Failure to do so while still operating
and accepting donations can result in violations of state law as well as federal tax law. The IRS or state attorneys general are also empowered to bring claims for violations of statutory nondistribution constraints in circumstances involving self-dealing by directors or officers.

Nonprofit directors and officers can also be sued by state attorneys general for violations of state or local regulations governing nonprofit organizations, misrepresentations in solicitations for donations, or failure to comply with applicable licensing requirements.

**Nonprofit Directors’ and Officers’ Claim Examples**

The following are several recent claim examples that highlight some of the unique exposures nonprofits and their directors and officers face. In particular, they also demonstrate the exposure to personal liability a director or officer may ultimately face, even for disputed claims of alleged misconduct.

**Breach of fiduciary duty.** The ouster of the president of a nonprofit arts organization and resulting myriad litigation demonstrates just how complicated and costly a breach of fiduciary lawsuit can become for a nonprofit.

In September 2012, the New York attorney general filed a lawsuit against O. Aldon James, the former president of the National Arts Club (NAC), a nonprofit charity chartered to foster and promote public interest in the arts. The complaint charged James with breach of fiduciary duty in connection with the organization’s assets, breach of fiduciary duty in connection with the administration of restricted assets, and false filings with the New York State Charities Bureau, and sought an accounting and restitution of the value of wasted corporate assets.

The suit alleged that James took advantage of his position as president of the NAC to commandeer more than a dozen apartments, offices, and other rentable club spaces at the NAC’s national headquarters, which he and his twin brother, John James, and their family friend, Steven Leitner, allegedly used for years while paying below market value rents or, in some cases, no rent at all. The complaint further alleged that James appointed Leitner to key positions within the NAC, to ensure that he and Leitner maintained control over the use of the NAC’s valuable real property. It was alleged that the NAC was deprived of not less than $1.5 million in rental income that it could have realized from the rent of these apartments and other spaces.

It was also alleged that James used NAC funds to go on personal shopping sprees at antique shops, flea markets, and vintage clothing stores and used club space to hoard the huge quantities of acquired items. In addition, the lawsuit charged James with improperly removing $274,000 from the Kesselring Fund, a restricted club endowment fund intended to support the dramatic arts. The suit charged that he used that fund to finance the restoration of the club building’s facade.

James’s ouster and the subsequent lawsuit by the attorney general appear to have been set into motion by James’s firing two employees in December 2010. The employees at issue retaliated by providing photographs of cluttered offices and apartments occupied by James at the NAC’s headquarters to one of the employee’s relatives, who posted them on the Internet. The website described what it claimed to be the decay of the historic landmark building, as well as reported potential fire hazards to other residents in the building due to alleged hoarding by James.
Shortly thereafter, a member of the NAC’s board reported what she believed to be financial improprie-
ties by James to the New York State Charities Bureau. The New York attorney general’s office subse-
quently commenced an investigation into the NAC. The NAC, in turn, sought disciplinary charges
against the James brothers and Leitner, seeking to end their memberships and evict them. The NAC
also entered into a settlement with the attorney general’s office requiring the organization to adopt
tighter financial controls and institute governance reforms.

James denied the allegations and filed several lawsuits against the NAC and its board. The James broth-
ers and Leitner sued the NAC and its board to ward off the NAC’s attempts to oust them from the NAC
and its apartments. James thereafter filed a derivative lawsuit on behalf of the NAC pursuant to N.Y.
Not-for-Profit Corporation Law (NPCL) § 720, against certain directors of the NAC for breaches of their
fiduciary duties and seeking an accounting for alleged improper activities and wasteful expenditure of
NAC resources. In his complaint, James claimed that several of the directors had attempted to seize
control of the NAC through unlawful means, eventually subjecting the NAC to government investiga-
tions, extensive litigation, and adverse publicity at great cost to the organization. In addition to an
accounting, James also sought the removal of several of the directors from their positions as officers of
the NAC.

James also filed suit against the NAC and several members of its board for alleged conversion of his
property in connection with the eviction. In his complaint, he also set forth a cause of action against
the locksmith who had changed the locks on his apartment for aiding and abetting the alleged conver-
sion. He claimed that the board’s alleged conversion of his property not only caused him to sustain
financial damage but also resulted in the destruction of evidence that could have enabled him in the
defense of the pending litigation against him.

The attorney general recently obtained a settlement resulting in payment of $950,000 in restitution by
James. In addition to restoring funds to the NAC’s general accounts, the settlement required the club
to apply $274,000 of the restitution obtained to replenish its Kesselring Fund. The terms of the settle-
ment also require James, his brother John, and Leitner to move out of the apartments as well as agree
to never again serve as a director or officer of a nonprofit organization in the state of New York. The
attorney general’s settlement also resolved all of the outstanding litigation between the NAC, James,
his brother, and Leitner. The NAC continues to remain subject to the earlier agreement with the attor-
ney general’s office that provides for governance reforms and tighter financial controls.

While the recovery on behalf of the NAC was a victory for the organization, it ultimately falls short of
the litigation costs the organization incurred in connection with the lawsuits, which are estimated to
have exceeded $1 million.

Mismanagement of charitable donations. In an example of a mismanagement claim, the New York
attorney general recently sued the directors of the Thoroughbred Retirement Foundation (TRF), one of
the largest nonprofit organizations devoted to retired racehorses, alleging they had driven the founda-
tion into insolvency and failed to provide money for the basic care of the more than 1,100 horses in
their control. In People ex rel. Schneiderman v. Moore, the attorney general alleges the foundation took
formal responsibility for more horses than it could afford, despite repeated warnings of financial dis-
stress from its own officers. It is alleged that, as a result of their failure to properly oversee and manage
the organization’s operations and finances, the directors drove the organization into insolvency, resulting in the neglect, suffering, and even death of horses in its care. The complaint alleges the board also engaged in a series of financially irresponsible transactions, borrowing to pay off existing debt and invading TRF’s restricted endowment fund, which has further damaged its ability to fulfill the non-profit’s charitable purpose of protecting thoroughbreds from neglect and mistreatment.

According to the lawsuit, the board diverted money meant for horses to help repay personal loans taken out by two of its members. Specifically, the lawsuit claims the board obtained a $1 million line of credit from a commercial bank affiliated with its then treasurer. The board then allegedly used a portion of the proceeds to repay more than $200,000 in outstanding personal loans to TRF from its treasurer and president.

It is alleged that, in order to secure the line of credit, TRF encumbered its largest asset, a $7 million restricted endowment fund from the estate of Paul Mellon dedicated to the support of the horses. The state alleges TRF encumbered the fund by pledging all of the income on the endowment fund and giving the bank the right to veto any material withdrawals from the fund. The complaint states that, in doing so, the board put at risk TRF’s only stable source of revenue and potentially risked its ability to draw down from the endowment fund further with donor or court authorization, if necessary, to safeguard the horses. Six months later, having exhausted the proceeds of the line of credit, the board allegedly invaded the endowment without authorization and spent $200,000 in excess of the permitted 5 percent annual expenditure, in clear violation of the fund’s restrictions.

The state seeks a judgment (1) removing TRF’s current directors for cause and permanently barring them from reelection to the board of TRF; (2) requiring the defendants to account for violating their statutory duties by causing the neglect of TRF horses and engaging in financial transactions that benefited individual directors and violated the restrictions on TRF’s endowment; (3) enjoining TRF and its directors from accepting additional horses into its herd without court approval; (4) enjoining TRF and its directors and officers from invading or otherwise misusing the endowment fund; and (5) appointing a temporary receiver to administer TRF’s assets, pending the reconstitution of its board. The defendants deny the allegations.

In another example of a claim for mismanagement of endowment funds, in May 2010, the California attorney general’s office filed a lawsuit to shut down the Monterey County AIDS Project (MCAP) after investigating allegations that former officers and directors of the charity had mismanaged money from an endowment fund earmarked for HIV/AIDS patients. The complaint set forth causes of action for (1) an accounting of charitable trust assets, (2) diversion and improper distribution of charitable assets, (3) breach of fiduciary duty for failure to use assets for restricted purpose, (4) breach of fiduciary duty for failure to take actions to recover improperly diverted funds, (5) negligence, (6) involuntary trustees, (7) constructive trust, (8) involuntary dissolution, and (9) other equitable relief and damages.

In 1999, Douglas Madsen bequeathed to MCAP $1.8 million in cash and property on a Big Sur ranch for housing people with HIV/AIDS. The next year, MCAP asked the county superior court for permission to sell the Madsen property, citing the logistical challenges of housing patients far from medical care. The court allowed it, but ordered MCAP to put proceeds from the property’s sale, along with assets from Madsen’s estate, into a dedicated endowment fund.
The complaint charged that the directors and officers either knowingly participated in the diversion of charitable assets or failed to make reasonable inquiry into the conduct of other MCAP officers and directors, which would have prevented the diversion of the charitable assets. The complaint charged that the MCAP directors raided the housing endowment fund and another $1 million in unrestricted funds for salaries, rent for the charity’s thrift shop, and various personal expenses and for-profit ventures.

The attorney general’s office and MCAP reached a settlement, the conditions of which required MCAP to officially dissolve and allow the attorney general to redistribute its charitable assets, including $1 million paid to the attorney general’s office by MCAP’s insurance company, to another organization, the Community Foundation for Monterey County. Accompanying injunctions barred a number of MCAP’s officers and board members from ever serving on another nonprofit board.

Violations of state regulations in connection with charitable solicitations. A recent example of a claim for violations of a board’s statutory obligations involved a state attorney general lawsuit against the Colorado Humane Society (CHS). In State ex rel. Suthers v. Colorado Humane Society, the attorney general detailed numerous ongoing violations of the Colorado Charitable Solicitations Act (CCSA), the Pet Animal Care and Facilities Act (PACFA), the Colorado Consumer Protection Act (CCPA), and the Colorado Revised Nonprofit Corporation Act (CRNCA) by the individual defendants. The complaint additionally alleged that CHS Executive Director Mary Warren, CHS Development Director Robert Warren, and Operations Director Stephanie Gardner wasted and misused CHS’s assets.

The lawsuit claimed the defendants ran CHS without any regard to its articles of incorporation and amended bylaws, and without regard for certain required corporate formalities, such as keeping board meeting minutes and proper accounting records. Specifically, the complaint alleged the individual defendants did not properly register the organization with the Colorado Secretary of State Charities Division, resulting in the organization soliciting over $5 million in donations from 2004 through 2007 in violation of the CCSA. The state further claimed that the defendants caused CHS to violate the CCSA by misrepresenting to Colorado consumers how their donations would be used. The complaint also alleged CHS additionally violated PACFA by misrepresenting CHS’s euthanasia policy and its euthanasia rate. Specifically, the state alleged that CHS claimed it euthanized less than 8 percent of its animals, when in reality, the rate in the five years preceding the filing of the lawsuit had been as high as 29 percent. The state argued that these violations of the CCSA and PACFA also constituted violations of the CCPA, subjecting CHS to significant financial liabilities, including potential civil penalties and attorney fees.

The suit also claimed the defendants grossly mismanaged the organization’s assets, including bouncing payroll checks and allowing its workers’ compensation insurance to lapse. While the case was pending, the court placed the shelter in custodianship to prevent further dissolution of the shelter’s assets. During the pendency of the case, the assets of CHS were sold, including its name.
The matter ultimately settled. As part of the settlement, Robert and Mary Warren were barred from operating or managing charitable organizations for the next decade. The Warrens were also prohibited from owning or operating any business covered by PACFA, such as an animal shelter, for five years. Gardner was barred from operating a charity for two years and operating any business covered by PACFA for one year.15

Available Protection for Directors and Officers

Some states have enacted liability limiting statutes to protect directors and officers of nonprofits. In 1997, the U.S. Congress enacted a federal statute, the Volunteer Protection Act of 1997 (VPA),16 which eliminates the liability of an individual volunteer for damage caused by his or her simple or ordinary negligence, so long as the individual was acting within the scope of his or her responsibility to the eligible organization and was not grossly negligent or intentionally trying to cause harm. The volunteer’s protection under the VPA is a qualified immunity against liability for certain tort claims. Claims that the injury was caused by gross negligence, by willful or criminal misconduct, or by a conscious and flagrant indifference to the victim’s rights or safety, are not within the scope of the protection afforded to volunteers by the VPA. The VPA also provides protection to the individual volunteer only; it does not immunize or otherwise limit or affect the liability of the organization itself. While the VPA can be raised as a defense to liability, its effectiveness is undercut by the fact that claims against directors or officers are usually pleaded to include claims of gross negligence or willful conduct in order to circumvent the statute.

Problematically, even when an organization may ultimately prevail against a claim, it may still incur significant legal costs in mounting a defense. In many cases, the costs of defending against a claim for management liability against a nonprofit can exceed the amount in controversy. Oftentimes, the most difficult cases to resolve involve claims where the relief sought is nonmonetary, and may include the removal of a board or directors or officers, the reversal of a transaction, or injunctive relief seeking an order prohibiting individuals or the organization from engaging in certain conduct. Consequently, these cases can drag on for years.

Funding the defense of these claims can be very burdensome for a nonprofit’s directors and officers. While some nonprofits may provide for indemnification to their directors and officers under the terms of their bylaws, the cost of defending a claim against an organization’s directors or officers may exceed the nonprofit’s available funding. Oftentimes, claims against directors and officers fall outside the scope of a nonprofit’s general liability or umbrella policies. Accordingly, many organizations purchase nonprofit directors and officers liability insurance coverage to minimize their exposure in the event of a claim. Subject to their terms and conditions, these policies provide coverage for both defense costs and damages attendant to claims, subject to some limitations.

Tips for Best Practices

By adhering to certain conduct and adopting and enforcing adequate policies, potential risks can be minimized. Below are several tips that directors and officers can adopt to protect their organization and themselves from risks and minimize their exposure:

• Carefully select qualified board members who include individuals with business or other necessary expertise;
• Ensure that board members read the bylaws and articles of incorporation and frequently review them to ensure the organization is in compliance;
• Replace board members who do not attend board meetings or otherwise do not fulfill their duties as board members;
• Ensure adequate minutes are taken at board meetings that accurately reflect the proceedings at the meeting;
• Have strong internal financial controls in place, including: regular internal audits, third-party review, dual signature requirements on checks over certain thresholds, and oversight by more than one person over day-to-day management of funds;
• Ensure that fundraising solicitation materials contain clear and accurate information on how donations will be used;
• Ensure an investigation plan for accusations of suspicions of misconduct is in place and is enforced;
• Ensure familiarity with any terms or restrictions on endowment funds or designated gifts prior to authorizing any transactions with respect to such funds;
• Be well acquainted with state regulations governing the operation of the organization, including licensing, standard of care, and disclosure requirements, and designate an individual within the organization or on the board to monitor any changes to such regulations;
• Ensure effective planning of programs and determine which programs are consistent with the organization’s mission and monitor their effectiveness;
• Verify state registration and licensing deadlines are met; and
• Assist in developing the annual budget and ensuring adequate funds are secured.

Conclusion
Understanding the potential risks of serving as a director or officer is critical for the management of any nonprofit organization. By taking adequate measures to minimize risk and adhering to requisite conduct, directors and officers can minimize potential risk and exposures not only for themselves but for the organization itself.

Notes
1. A copy of the MNCA is available at http://meetings.abanet.org/webupload/commupload/CLS580000/sitesofinterest_files/FinalMNCA.DOC.
3. The allegations set forth in the complaints summarized below may be without substance and are provided for informational purposes only. Nothing contained in this article is intended to suggest that they have any legal or factual merit.
12. *Id.* §§ 55-80-101 through -117.
13. *Id.* §§ 6-1-101 through -1115.
14. *Id.* §§ 7-121-101 through -137.