

# Board Member Legal Responsibilities

By Jerald A. Jacobs

The legal responsibilities of directors and officers of nonprofit organizations have been much in the news in recent years. Both houses of Congress have highlighted what they see as governance inadequacies by nonprofits. The 2002 Sarbanes-Oxley Act, affecting publicly traded business organizations, has raised the standards and expectations for the governance of all entities—including nonprofits. The Internal Revenue Service has focused on governance issues of tax-exempt organizations by requiring, in the new Form 990 (2008) annual tax return, disclosure on more than a dozen governance issues. (For more on the new Form 990, see page 60.)

Directors and officers of nonprofit organizations, though they serve voluntarily and without compensation, have a fiduciary duty to their organizations. A breach of that duty could mean personal and individual liability by the director or officer to the organization for any damages caused.

## Director and Officer Duties

"Fiduciary duty" equates with loyalty and encompasses the following four main legal principles:

**1. The duty to act in the best interests of the organization.** This duty is very broad, requiring directors and officers to exercise ordinary and reasonable care in performing their duties. When acting in their capacity of serving the organization, they must put the organization's best interests ahead of any other interests.

**2. The duty to disclose other interests and avoid conflicts.** It is common for a director of a nonprofit organization to have other interests besides those of the organization itself. One might work in a commercial firm that does business with the nonprofit organization. One might also belong to—or be a leader in—a competing nonprofit organization or one on the opposite side of public-policy matters. The fiduciary duty of a director or officer requires disclosure of these other interests to the extent and in the manner that is requested by the nonprofit organization served.

Depending upon how the nonprofit organization interprets "other interests" disclosed by directors and officers, it may conclude that there is a conflict of interest. A conflict of interest is, ultimately, what the organization defines it to be. A conflict may exist most commonly when a director or officer participates in the deliberation and resolution of an issue important to the organization while simultaneously having professional, business, or volunteer responsibilities outside of the organization that could predispose the individual one way or another. The board has the ultimate say in reviewing other interests disclosed by directors and officers, in determining whether there is a conflict, and in resolving how to mitigate that conflict.

It is not sufficient for the director or officer to merely be aware of the conflict and to attempt to act in the organization's best interest. The director or officer must disclose whatever other interests are specified for disclosure. Most often, the disclosure itself will be considered by the nonprofit organization to be sufficient; the other directors or officers will have been warned of the disclosing individual's possible bias. But for some other interests that are disclosed, the organization may ask that the individual refrain from participation in the organization's resolution of the issue that is the subject of the disclosure. For very rare pervasive conflicts, withdrawal from the volunteer position or from the outside conflicting responsibility may be the only alternative to ensure unbiased decision making.

**3. The duty to maintain the organization's information in confidence.** This applies not only to information that has been marked "confidential" but also to information that the director or officer reasonably should expect the organization to want to keep confidential. Real-estate proposals or other transactions being considered by the organization are obvious examples. The same is true for strategies or prospects for litigation involving the organization.

**4. The duty to respect corporate opportunities.** Fiduciary duty does not prohibit competition by an organization's directors or officers with the organization itself. Those individuals may generally engage in the same areas of endeavor as the organization, provided such engagement causes no unfair injury to the organization.

One form of competition that is not permitted is appropriating corporate opportunities. A corporate opportunity is a business prospect, idea, or investment that is related to the activities or programs of the organization that the individual knows or should know would be in the best interests of the organization to pursue.

## Other Legal Issues

**Apparent authority.** The U.S. Supreme Court has held a trade association responsible for the illegal activities of its volunteers where the volunteer only "appeared" to be acting with the authority of the organization. In that case, the trade association's board of directors did not approve the activities, did not benefit from them, and did not even know about them. Nonprofits must limit who, among their directors and officers, is authorized to act or speak for the organizations.

**Antitrust liability.** Many types of nonprofit-organization policies and programs can lead to serious legal liability if they tend to inhibit competition. Federal and state antitrust laws promote open and fair competition in all commercial endeavors; among other prescriptions, they require that businesses or professions make decisions on key competitive issues—such as prices or where or with whom to do business—on an individual basis rather than on a joint basis. Since the 1970s, it has been clear that federal antitrust laws apply with full force not only to businesses but also to professions and their

societies. Many nonprofit organizations are composed of members that compete with one another in their businesses or professions. Therefore, virtually any action that a nonprofit organization takes may raise antitrust issues.

A broad range of lawful activities relating to standard setting, certification, dispute resolution, and various other forms of self-regulation may be undertaken. Great care must be taken, however, to ensure that an organization's activities do not fall within categories the courts have established as anticompetitive when undertaken jointly rather than individually. Prices and fees are a particularly sensitive area. Any action of a nonprofit organization that directly raises, lowers, or stabilizes prices or fees has the highest risk of antitrust scrutiny and the greatest potential penalties. Even an action that may only indirectly affect prices and fees—such as arrangements on terms and condition of sale, warranties, limitations on the extent or type of advertising, and hours of operation—can be expected to attract antitrust scrutiny.

Antitrust violations may be prosecuted by the federal or state government, either civilly or criminally, and by injured private individuals or entities. Courts may award injunctive relief against violators and may require violators to pay victims three times the financial injury actually suffered, plus their attorneys' fees.

Violations fall into two basic categories: actions that are unlawful without regard to their actual impact on competition (called *per se* violations) and actions that are not necessarily unlawful but may be so depending on their actual impact on competitive conditions (called rule-of-reason violations). Actions that are likely *per se* unlawful include the following:

- Agreements fixing prices or setting floors or ceilings on prices;
- Agreements to boycott competitors, suppliers, third-party payers, or customers, patients, or clients;
- Agreements among competitors dividing or allocating markets;
- Agreements coerced by a provider with a dominant market position tying the purchase or provision of one product or service to the purchase or provision of another product or service.

Any other agreement, including resolutions of a nonprofit organization where members are competitors, may violate the antitrust laws under a "rule of reason" analysis if its effect is generally to raise prices or fees or to reduce the quality or quantity of available goods or services.

Antitrust laws can be violated by mutual understandings or other informal arrangements falling far short of a formal contract or written resolution. Directors and officers of nonprofits, or just ordinary members, can implicate their organizations in antitrust violations by using the organizations to facilitate their undertaking anticompetitive arrangements, even without invoking any of the formal mechanisms of the organization.

Courts have often stretched to find that attendees at meetings have agreed upon joint anticompetitive business or professional conduct. It is not necessary, when government or private challengers are attempting to prove an antitrust conspiracy, to show that the alleged conspirators actually signed a document committing themselves to illegal conduct or even to show that they agreed clearly in conversations to commit to the conduct. Discussions at meetings in which the plans for a conspiracy were "signaled" among the meeting attendees, followed by parallel anticompetitive activity of the attendees consistent with the discussions, has been sufficient to support a finding of an antitrust "contract, combination, or conspiracy" that is in violation of the law. Nonprofit organizations must avoid discussions in which competitors attending meetings are "signaling" their illegal intentions.

### Avoiding Legal Liability

To avoid legal pitfalls, a top-down commitment by the organization's directors and officers to operate fully within the law is essential. Where the law is unclear, a conservative approach is warranted.

Next, education is important. Legal compliance requires frequent explanation to the volunteers of the legal risks facing organizations. Orientation programs for each newly elected or appointed director, as well as ongoing education, should include a component on compliance challenges.

The availability of legal counsel is also essential. Counsel should be charged with the role of monitoring policies and programs and bringing issues of potential risk to the attention of the directors and officers.

Every state permits nonprofit corporations to indemnify their directors and officers. Indemnification can be written into the bylaws or effected merely by a board resolution when necessary. Indemnification is the promise of the organization to pay for the legal defense—and any ultimate damages—if a director, officer, other volunteer, employee, or agent is accused of legal wrongdoing while acting on behalf of the organization.

Perhaps the ultimate safety net is insurance. Many carriers offer broad liability insurance policies tailored to the needs of nonprofit organizations. The policies ordinarily treat as "insured parties" not only the organization itself but also all volunteers and staff. The policies will pay the legal defense costs and any resulting settlements or damages from claims of wrongdoing by the insured organization or its leadership.

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