A Guide for Directors of Nonprofit Organizations in Michigan

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SECTION I

PURPOSE OF THE BOARD

The overall purpose of the board of directors of a nonprofit organization is not to manage the day-to-day activities of the organization, but to monitor the results of day-to-day managers. Boards assume this responsibility by exercise of two general functions: taking action and gathering feedback. Taken together, these two functions create an ongoing cycle through which the board of directors is able to govern the nonprofit organization effectively. The board takes action through its decisions and the delegation of its duties and responsibilities. The board then receives feedback from the individuals and committees to whom duties and responsibilities have been delegated, as well as from outside experts, attorneys, accountants, and others, who either supply information or assess and analyze issues as requested.

The responsibilities of the board can be separated into three major areas:

- Defining the mission of the organization;
- Planning the budget and other financial aspects of the organization; and
- Selecting and overseeing the organization's staff.

Mission

The extent of the board's work - the cycle of action and feedback within certain parameters - is dictated by the purposes and goals of the organization. Boards should develop and maintain a meaningful statement of the organization's mission to clearly define working parameters. A mission statement serves to focus the board, and the organization as a whole, on long-term objectives. The board is responsible for the initiation, periodic review, and refinement of the mission statement and developing related strategies to accomplish the organization's goals.

Financial Planning

The board of directors is also responsible for financial planning. A principal function of many nonprofit organizations is raising funds. In most business organizations, capital is a resource necessary to create an end product or service. However, for many nonprofits, financial resources are the end product. For example, the objective of the Juvenile Diabetes Foundation (JDF) is to support diabetes research. While the JDF's ultimate desire is that a cure or more effective treatment for the disease be discovered, the

Governance Structure

There are essentially two governance structures available to Michigan nonprofit corporations: directorship and membership. The articles of incorporation must specify whether the corporation is organized on a membership or directorship basis.

In a directorship corporation, there is a single governing body, such as a board of directors or trustees, that is usually self-perpetuating. Although the articles of incorporation will indicate whether members of the governing board are called "directors" or "trustees," the distinction is one in name only.

In a membership corporation (whose members may also be called "shareholders"), there are two tiers of governance: the members, whose primary responsibility is to elect the board, and the board itself. In larger nonprofit corporations, contributors often comprise the membership. By making contributors voting members of the corporation, many organizations seek to expand group ownership, trust, and commitment. However, certain actions, such as amending the articles of incorporation or approving a merger or sale of substantial assets of the corporation, can only be taken with membership approval. Waiting for the members' annual meeting, in these instances, may delay needed action. In addition, some organizations have difficulty maintaining an accurate, up-to-date list of all members.

Most nonprofit corporations find that corporate governance can be streamlined by organizing as a directorship corporation with a single governing body. A directorship corporation may still have members, but they would be non-voting members.

Meetings

A board conducts the business of a nonprofit corporation in one of two ways: through formal action adopted at a board meeting, or by unanimous written consent. Michigan law allows the board of a nonprofit corporation to hold regular or special meetings as needed. Although the law does not specify a minimum number of meetings, boards typically meet quarterly or monthly. A regular schedule of meetings is critical for directors to meet their fiduciary duties as outlined in Section 3. Michigan law provides a further incentive for directors to attend board meetings: In some circumstances, a director is assumed to have consented to action taken by the board during his or her absence. In other words, an individual director may be held accountable for board decisions made while he or she was not present. A director may, however, file a formal dissent to board action after the meeting.

The president is generally the chief executive officer and has the responsibility of supervising and controlling the activities and affairs of the nonprofit corporation. The president is further responsible for executing documents authorized by the board of directors. In the president's absence, his or her duties are often delegated to the vice president. The president may be a volunteer board member or may be an employee of the organization.

The chairperson presides over the meetings of directors and members. In the event that a corporation has only a president or chairperson, that individual is generally responsible for the duties of both offices. Nonprofit organizations sometimes give the chief executive officer the title "executive director." This title may indicate that the position is a staff position rather than one with policy-setting authority.

The secretary of a nonprofit corporation is traditionally responsible for compiling meeting minutes, maintaining corporate records, and ensuring that directors receive notice of meetings. The treasurer's responsibilities include oversight of receipts, payables, and other items related to the cash flow of the corporation; facilitation of audits; and supervision of reports concerning the financial standing of the corporation. The traditional day-to-day responsibilities of both the secretary and treasurer are usually conducted by staff members in today's larger nonprofit corporations, as the positions have become increasingly honorary. Nonetheless, the "honorary" officer should take seriously the responsibility of monitoring the performance of the individuals to whom these functions have been delegated.

Committees

While specific tasks of the board are often delegated to corporate officers, committees of the board are instrumental in developing and executing corporate strategy. Although Michigan law allows for the extensive use of committees, there are limits to the board's ability to delegate authority. In Michigan, the board of a nonprofit corporation may not delegate its power to amend the articles of incorporation; adopt an agreement of merger or consolidation; recommend the sale, lease or exchange of substantial property or assets of the corporation; recommend the dissolution of the corporation; amend the bylaws of the corporation; fill vacancies in the board; fix compensation of directors; or cancel stock or terminate membership in the corporation.

There are three major types of committees which may be designated by the board: standing committees, advisory committees, and ad hoc committees.

Standing (or oversight) committees are usually permanent committees.

"mediocre." It simply means that the director is not expected to possess any technical expertise or specialization. "Prudence" means that the director is expected to possess and exercise sound practical judgment and common sense, and reach informed conclusions. Prudence, however, does not require excessive caution.

A director must exercise care. The concept of "care" incorporates both diligence and attention. Diligence requires an active interest, such as attending meetings, reading materials, and otherwise making an effort to learn about the corporation and its activities. Diligence is often viewed as an objective standard based on the amount of time dedicated to a task. Attention requires alertness and suggests anticipation of potential problems and issues.

A director's satisfaction of the duty of care is measured in comparison to individuals in similar circumstances in like positions. Comparing the performance of a director to others in a like position allows for flexibility based upon the uniqueness of the specific nonprofit corporation for which the director serves. Circumstances surrounding a decision at the time it was made are also considered. By viewing a decision within the context of similar circumstances, the standard takes into account the specific factors that shape decisions.

The statutory duty of care in Michigan allows for the director's reliance on experts both inside and outside of the nonprofit corporation, including accountants and attorneys. Although reliance on another party does not relieve a director of his or her individual duty of care, it does provide a measure of protection if the experts relied upon have been selected with reasonable care in accordance with the standards set forth above. For example, a director can rely on the financial reports of a reputable accounting firm, but not on reports prepared by an accountant whose competence or integrity is in question.

In business corporations, directors who have satisfied the duty of care are afforded the protection of the "business judgment rule." This rule prevents courts from second-guessing the past business decisions of directors. The business judgment rule is intended to provide total protection from liability for decisions so long as the business decision had a reasonable basis of rationality, involved no conflict of interest, and was a reasonably informed one. The application of this rule in business corporations provides directors with a safe harbor in which to increase economic returns by taking calculated risks.

Directors of nonprofit corporations, however, are not measured by economic or market performance. Although the business judgment rule applies most directly to business corporations, it is easily analogized to nonprofit corporations. The business judgment rule protects directors of nonprofit corporations from liability in order to

benefit the corporation. The loan or guarantee may be with or without interest and may be unsecured or secured in a manner that the board approves. When approving such a transaction for an interested director, however, each non-interested director must be careful not to violate the duty of care. In addition, both the interested director and the nonprofit charitable corporation must ensure that the transaction does not give rise to a personal benefit in violation of federal tax laws (i.e., "private inurement"). Directors who vote for, or concur in, making a loan to an officer or director in violation of the Michigan Nonprofit Corporation Act will be held jointly and severally liable to the corporation for any injury suffered by creditors, shareholders, or members of the corporation as a result of making the loan.

As previously stated, most duty of loyalty violations will result in conflicts of interest. Conflicts of interest can be avoided by taking a number of precautionary measures:

◆ The first and most important relates to the composition of the governing board. Directors should be financially disinterested from the organization to the greatest possible extent. Small, weak boards which are dominated by one or a few dominant directors are more likely to see conflicts of interest arising from the dominant director's or dominant group's ability to achieve personal gain.

◆ Second, all directors should have a working knowledge of applicable IRS rules in order to recognize situations which may endanger the tax-exempt status of the organization as a result of private benefit or self-dealing.

◆ Third, a formal policy should be established to address potential conflicts as they arise. The policy should include procedures for disclosing the material facts of proposed contracts and transactions with directors while still preserving the privacy of the individual director. The policy should also include procedures for determining whether a contract or transaction is fair and in the best interests of the organization. For example, before a nonprofit organization enters into a major contract for services with a company owned by one of the organization's directors, the board should satisfy itself that a more favorable arrangement is not available on similar terms from a different company.

A conflict of interest policy should be in writing and encompass three key elements: awareness, disclosure, and disinterested review. First, the board must be aware of any personal interests a director or directors may have related to an upcoming transaction prior to the board meeting. To assist directors in recognizing possible conflicts, the organization should require each board member to complete an annual questionnaire disclosing relevant ownership interests and affiliations. Second, the director should disclose any such interest to the board before it takes action on a related transaction.

Section 4

LIABILITIES OF DIRECTORS

Generally, the board of directors of a corporation cannot be held liable for the actions of management and staff. The corporate entity is responsible for acts committed by employees, and corporate liability is usually limited to the assets of the corporation. However, in some situations, individual board members may be held personally liable for their actions as directors.

Breach of Duties

The largest source of personal liability for an individual director is a breach of the fiduciary duties discussed in Section 2. It is important to note that these duties are owed only to the corporation and, accordingly, may be enforced only by an individual with an interest in, and acting on behalf of, the corporation - such as another director, or an officer, shareholder, or member. The Michigan Attorney General also is charged with representing the interest of the general public relative to charitable organizations. Thus, an action may be brought by the Attorney General against nonprofit directors on behalf of the public if the Attorney General feels it is necessary to protect the public interest.

Directors who use power or information obtained through their positions for their own benefit are vulnerable to personal liability. This behavior is often referred to as "self-dealing." For example, a director who learns at a board meeting that a parcel of land adjoining the corporation's property will soon be made available for sale and purchases the land for his own account before the organization can act would be liable for self-dealing. By the same token, a director may be held liable for engaging in self-dealing for the benefit of family, friends, or other third parties. For instance, a director who causes the nonprofit organization to deposit large sums of corporate funds in a non-interest-bearing account at a financial institution controlled by his family may be liable for self-dealing.

Liability for Board Actions

Liability may be imposed upon individual directors who vote for or concur in actions taken by the board collectively, if the action is prohibited under state or federal law. For example, the director of a trade association whose board conspires to violate antitrust laws may be held individually liable for the organization's illegal activities or policies.

As mentioned earlier, Michigan law provides that in some situations a

the directors may be held personally liable if a child is injured because a safety requirement has not been met. The corporate entity can, of course, be held responsible for the negligent acts of employees performed as part of their duties. It is rare, however, for directors to be held individually liable for the negligence of employees.

Lack of Corporate Identity

Individual director liability may also result if it is determined that the nonprofit corporation does not exist as a separate entity, but merely as an alter ego of a dominant director. In such circumstances, individual liability may be imposed on the dominant director by "piercing the corporate veil." The requirements for piercing the corporate veil are: (1) the corporation does not maintain an existence separate from the dominant director, and (2) fraud or injustice would occur if the corporate veil were not pierced.

Courts consider several factors when determining whether the separate existence of a corporation is legitimate, including:

- Compliance with corporate formalities such as maintaining corporate records and holding regular meetings;
- The separation of corporate and personal assets; and
- The use of corporate assets by the individual as his or her own personal assets.

If a nonprofit corporation has been established for the sole purpose of benefitting and protecting a dominant director, that director will not be allowed to use the corporate structure as a defense to personal liability.

Statutory Liability

Personal liability of directors of nonprofit corporations may also result from violations of state or federal statutes. For example, Michigan law states that any officer or agent of a nonprofit corporation who knowingly falsifies or wrongfully alters books, records, or accounts of the corporation is guilty of a misdemeanor and subject to fines. Tax laws impose personal liability on officers who are responsible for paying withholding and employment taxes on behalf of a corporate employer and fail to do so. Officers and directors may also be held individually liable for gaining personal profit at the expense of a retirement plan under the provisions of the Employee Retirement Income Security Act (ERISA).

In 1996, the Internal Revenue Code was amended to create "intermediate sanctions" designed to penalize officers and board members who receive

volunteer directors from personal liability resulting from actions taken within the scope of their role as directors. Specifically, the Michigan Nonprofit Corporation Act allows a nonprofit corporation to limit the liability of its volunteers in three respects.

First, the Act provides that the nonprofit corporation may limit the liability of volunteer directors and officers to the corporation and its members for monetary damages for a breach of fiduciary duty. This limitation on liability is subject to certain exclusions, including a breach of the duty of loyalty, actions not in good faith or involving intentional misconduct, knowing violations of the law, other unlawful acts relating to loans or the distribution of corporate assets, transactions from which the director or officer derived an improper personal benefit, and actions that amount to gross negligence.

Second, the Act provides that tax-exempt charitable corporations - those described in Section 501(c)(3) of Internal Revenue Code - may assume the liability of volunteer directors to third parties for acts or omissions if the liability was incurred in good faith performance of the director's duties.

Finally, the Act provides that a nonprofit corporation may assume the liability for all acts or omissions of a volunteer director, volunteer officer or other volunteer provided that the volunteer was acting in good faith and within the scope of his or her authority. The volunteer will not, however, be protected if his or her conduct amounted to gross negligence or willful and wanton misconduct or was an intentional wrongful act.

The provisions of the Act permitting limited liability for directors, applies only to "volunteer directors." The term volunteer director is defined as a director who does not receive anything of more than nominal value from the corporation for serving as a director other than reasonable per diem compensation and reimbursement for actual, reasonable and necessary expenses incurred in his or her capacity as a director. Per diem means "per day" and is a reference to the practice of paying directors a specified amount for each meeting attended, as opposed to the policy of paying directors an annual salary or retainer. Thus, directors who receive only per diem fees for attending meetings would be eligible for the statutory protections, while directors who are paid an annual retainer would not.

Nonprofit volunteers should note, however, that the limitation of liability is not automatic. In order to protect volunteer directors or officers or other

An organization considering a D&O policy or renewing its coverage should ensure that the policy is tailored to nonprofit organizations. D&O policies that are available to nonprofit corporations often will cover wrongful discharge claims brought by terminated employees. This coverage is not usually available in D&O policies issued to business corporations.

Section 6

SARBANES-OXLEY

In response to governance abuses in the business sector, Congress enacted the Sarbanes-Oxley Act in 2002. While principally directed at publicly traded business corporations, two provisions have broader application and do apply to nonprofits. The first is a whistleblower provision that makes it a federal offense to retaliate against a person who provides law enforcement officers with information relating to the commission or possible commission of a federal offense. As a result of this law, many nonprofits have adopted so-called whistleblower policies to institutionalize the organization's intent to cooperate in any such investigation. These policies must be carefully drafted, however, to avoid creating a private cause of action for retaliation that does not otherwise exist under the law.

The second Sarbanes-Oxley provision that applies to nonprofits is a prohibition against knowingly altering or destroying records or documents with the intent to obstruct a federal investigation or a bankruptcy case. Nonprofits should adopt policies to alert employees, officers and directors of this obligation.

Although not otherwise applicable to nonprofits, Sarbanes-Oxley has been viewed as promoting best practices in the nonprofit sector regarding governance. Some examples of changes adopted by nonprofits: establishing audit committees, revamping audit committee charters to ensure independence and build in other safeguards, and requiring the CEO to sign IRS information returns thereby personally certifying the accuracy of the reports.

CONCLUSION

Nonprofit board members are not expected to be experts in the area of director conduct and liability. However, by gaining a general understanding of the obligations that accompany a director position, an individual should be able to identify potential problems. Anticipating potential problems and seeking assistance in resolving them will help the individual director avoid a breach of fiduciary duty and possible personal liability claim. With the ability to identify issues before they become problems, board members can direct their attention and energies to serving the organization and fulfilling its mission.

Clark Hill is a full-service law firm of more than 350 lawyers, with a tax-exempt organizations practice that is first among Michigan firms. Our nonprofit clients range from large national institutions to the smallest family foundations and grassroots volunteer organizations. The firm takes special pride in its longstanding tradition of service to charitable, civic and community organizations, and, in that spirit, we are pleased to present this publication to the field.

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