NATIONAL DIRECTORS INSTITUTE | NDI Executive Exchange

Non-Profit Organizations: Leading Through Transformational Change

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FOLEY

FOLEY & LARDNER LLP

Panelists

- **Renée Herzing**
  Herzing University
- **Jim Rauh**
  BloodCenter of Wisconsin
- **Dorri McWhorter**
  YWCA Metropolitan Chicago
- **Michael Schamberger**
  Ronald McDonald House Charities of Chicagoland & NW Indiana
- **Paul Melville**
  Illinois St Andrews Society, Chicago

Conversion from For-Profit to Non-Profit: Renée Herzing, President of Herzing University

- Founded in 1965; initially focused on technical programming
- Today: 11 campuses in eight states and online division
- Current enrollment of approximately 6,000 students
- Focuses on nursing, healthcare, business
- In 2015, Herzing University converts to a Non-profit University
- Focus on continued growth in career fields; Changes in educational and regulatory landscape

Industry Consolidation / Geographic Expansion
Jim Rauh, Chairman of BloodCenter of Wisconsin

- Founded in 1947 as part of Junior League blood-banking effort
- Today, has multiple service offerings:
  - Diagnostic laboratory testing
  - Treatment of blood and clotting disorders
  - Research (including technology spin-off)
- In 2012, announced alliance with Heartland Blood Centers of Aurora, Ill. expands impact to the greater Chicago Area
- In 2013, announces alliance with Michigan Blood
- Formed new parent “Versiti” to centralize leadership (while retaining important local engagement) of consolidating industry
- Focus on continuous growth; diversification into research

Shift to Social Enterprise & Revenue Diversification: Dorri McWhorter, CEO of YWCA Metropolitan Chicago

- Founded in 1876; traditionally provided family support (child care provider) and health services
- YWCA experienced reduced government funding leading to budget difficulties
- Focus on Revenue Diversification:
  - Exploring new revenue streams though e-commerce and merchandising
  - Social enterprise / programs that generate revenue

Developing to Meet Fundraising Needs
Michael Schamberger – Director, Ronald McDonald House Charities of Chicagoland & NW Indiana

- The vision of RMHC-CNI is to enhance the health, well-being, and education of children
- In 2008, RMHC-CNI launched the construction of a brand new 66 room, 15 story house in downtown Chicago
  - Significant funds raised
  - Construction Loan
  - Strategic increase in the Board size to boost fundraising efforts

Managing the Capital Campaign
Paul Melville, Illinois St Andrews Society

- Founded in 1841, Illinois St Andrews Society is the oldest 501(c) in Illinois and the largest Scottish cultural organization in North America
- In addition to the cultural aspects it operates The Scottish Home, which has for over 100 years offered a wide range of assisted living and nursing services
- In Summer 2016 we successfully opened the Caledonian House a purpose built facility specializing in helping suffers of Alzheimer's disease
- The Caledonian House came about following a strategic assessment of our assisted living operation, the needs of the community and how we could continue to be relevant.
- The project involved a number of challenges including
  - Capital Campaign
  - Construction Loan
  - Facility Launch

Responding to a Changing Environment

- Identification of Change
  - Economic Shocks
  - Opportunities / Threats
- Development of New Strategy or Tactics

Overcoming Hurdles to Change

- External
  - Finances
  - Donors / Government Programs
  - Regulatory
  - Charitable Beneficiaries
  - Public
- Internal
  - Staff
  - Board?

Managing the Board of Directors

- Education about new environment
- Developing Strategic Thinking
  - Retreats
  - Consultants
  - New concepts, new ideas
- Encouraging Director Engagement
- Disagreement; resistance to change
  - Ensuring adequate review and discussion
  - Resolving issues and moving forward
- Addressing Conflicts of Interest

Board of Directors as a Resource

- Strategic Thinking
- Sounding Board / Advisors to Executive
- Providing different perspective
  - Business leaders to help organization "act like a business"
  - Social Enterprise
  - Expertise in Specific Areas – i.e., web technology
- Diversity
- Collaborating Organizations
- Fundraising

Address Conflict of Interest / Excess Benefits

- Conflict of Interest
  - Every organization should adopt a proper Conflict of Interest Policy
    - Require disclosure of all potential conflicts
    - Exclude interested director from vote relating to a conflict
- Intermediate Sanctions and Excess Benefits
  - Intermediate sanctions apply if a disqualified person receives an excess benefit from an organization
    - Disqualified Person: officer, director, or individual with substantial influence over organization
    - Excess Benefit:
      - Value of what a disqualified person receives exceeds the value of what they were entitled to receive
      - Compensation in excess of reasonable compensation

NON-PROFIT ORGANIZATIONS

GENERAL ISSUES FOR THE BOARD OF DIRECTORS

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This outline references the Model Nonprofit Corporation ACT ("MNCA"), Third Edition (2008). Most states have not adopted the entire model act and it is important to review the governing act. For instance, the law governing nonstock corporations in Delaware is the same as the law that governs for-profit corporations (Delaware General Corporation Law).

I. <u>Board of Directors as the Governing Body</u>

A. <u>Board Requirement</u>.

A nonprofit corporation must have a board of directors. MNCA §8.01. Generally, "…[A]ll corporate powers must be exercised by or under the authority of the board of directors of the nonprofit corporation and the activities and affairs of the corporation must be managed by or under the direction, and subject to the oversight, of its board of directors."

B. <u>Size</u>.

States differ, but generally a board must include three directors. Directors must generally be individuals (entities cannot serve as directors). A common mistake made by organizations is to create a board of directors with too many directors. If a large board is desired, consider authorizing an executive committee which will have the authority to act for the entire board if it is not in session. Alternatively, keep the main board small and create advisory committees or groups. For a deliberative board of directors, 6-12 members is recommended. This is large enough to allow for dissenting views and a fair amount of diversity but small enough to have every director fully engaged in the discussion. If the organization believes it must elect donors as directors in order to fundraise successfully, then it may have to compromise and have a larger board. The organization may want to counteract a larger board by emphasizing the decision-making power of an executive board or committee structure. Many high profile organizations operate in this manner to great success.

C. <u>Board Make-up</u>.

The organization may formally (in its bylaws) or informally designate "slots" or preferences as to the types of people to serve in each role. This is especially important if the organization's board must or should represent certain constituencies or if the organization needs expertise in its board. Sometimes organizations draft and adopt formal statements to ensure this representation.

Designations may include:

i. Many organizations have the President or Chief Executive Officer serve on the board of directors *ex officio*—that is, he or she serves as a director by virtue of being elected President or CEO.

ii. Leaders of another organization may also serve *ex officio* (e.g., if the organization is a fundraising foundation for the local church, the pastor sits on the board of directors).

iii. Expertise/Qualifications.

iv. Commitment – both in time and financial.

v. Fundraising capability.

vi. Representative constituents / community members.

D. <u>Terms</u>.

The bylaws should generally state a term for the directors. However, for foundations that are closely affiliated with a particular donor or business, the directors may serve until resignation, death, or removal by the donor or business. The bylaws may also contain a term limit. This is a good idea – term limits discourage "collecting" board seats, helps ensure new blood in the organization and avoids difficult future discussions with directors who have become unengaged but do not wish to give up their seat. While generalities are difficult, a three-year term (with a stagger, so that one-third of the board is elected each year) is a good starting point. The bylaws also may include term limits (the number of terms a director may be re-elected) for similar reasons.

E. <u>Committees</u>.

Committees are used in different ways and for different purposes. In general, there are two types of committees: (i) advisory committees and (ii) committees with board-delegated powers.

An advisory committee may be made up of board members and non-board members, but it would only report its recommendations or findings to the board, which would then act on the recommendations. A committee with board-delegated powers generally must be made up only of board members.

The bylaws may provide for specific committees and/or allow for the board to create committees and appoint individuals to serve. If the board is delegating its powers to a committee, this delegation should be clear and exact.

Board committees that are important for governance are:

i. Executive Committee to act on behalf of the organization in lieu of the full board. The delegation to the executive committee may be complete or it may be limited in some way (i.e., cannot remove directors and officers, cannot amend the bylaws, or cannot adopt a budget).

ii. Compensation Committee to set compensation (if the executives are paid).

iii. Audit Committee to review and approve the financials.

iv. Governance and Nomination Committee to recruit and nominate new board members (with an eye towards diversity, expertise, fundraising, and representation goals).

F. Meetings of the Board of Directors.

Under state law, organizations must have an annual meeting and also have regular meetings and special meetings. The organization may also have regular meetings and special meetings of either members or directors. The bylaws may state that notice is not required for regularly scheduled meetings. Meetings must be called and noticed appropriately, if notice is required. The bylaws should state what qualifies for notice. Generally, if the notice requirements have not been met, any actions taken at the meeting may be considered void.

The bylaws should specify if the board may take action in lieu of a meeting by use of a written consent. Some states allow board action by less than unanimous consent if the articles or the bylaws contain a provision allowing for it. If appropriate under state law, an organization can consider e-mail to be acceptable for taking a written consent, but the e-mail consent will need to meet the requirements for an electronic signature – an e-mail string may not be sufficient.

The bylaws should specify the quorum and state the number of votes for the board to take action. This is generally the majority of directors present, but the bylaws may contain a provision requiring a higher standard (the majority of directors in office; two-thirds of the directors in office) for certain actions, such as amendments to the bylaws.

II. Fiduciary Duties

A. Duty of Care.

A director must act in good faith. MNCA §8.30(a)(1). Compliance with the fiduciary duty of care requires that the director makes decisions on a fully informed basis. This includes:

i. Making reasonable inquiries, actively obtaining all material facts reasonably available and pursuing all reasonably available sources of information or knowledge (e.g., discussing the matter with officers of the organization as well as independent advisors retained by the organization, including outside legal counsel and financial advisors) to make an informed decision.

ii. Making further independent inquiry when the director's particular knowledge or experience warrant.

iii. Performing independent homework or due diligence in connection with important decisions, including:

a. Reviewing, <u>in advance</u> of meetings, all background materials and material documents relating to actions that will be subject to Board approval.

b. Asking for and receiving, <u>in advance</u> of meetings, if appropriate, summary reports from management and/or professionals to explain the intent, content, implications and risks associated with each material document and action that will be subject to Board approval.

c. Asking pertinent questions and receiving satisfactory answers from competent sources.

In satisfying the duty of care obligations, a director may rely on the advice and reports of experts (*e.g.*, attorneys, accountants, financial advisors and appraisers) if the director believes, in good faith, that the subject matter is within the expert's area of expertise and the expert is fully informed. A director may also rely on the advice and reports of those officers or employees that are most familiar with the subject matter if the director believes, in good faith, that the officers or employees are reliable and competent in such matters. Similarly, a director may rely on the advice and reports of committees of the board if the director believes, in good faith, that it is reasonable to do so. In any case, reliance on the advice of another is not appropriate when the director has knowledge of facts or circumstances that make such reliance unwarranted. *See* MNCA §8.30.

Importantly, the standard of care applies to the decision-making process itself, not to the ultimate decision of the board. In other words, a director can make, without a violation his or her duty of care, a decision that in hindsight was not the best one, provided that it was a fully informed decision made with a good faith belief that the decision was in furtherance of the organization's charitable purposes.

B. <u>Duty of Loyalty / Conflict of Interest</u>.

The duty of loyalty requires directors to exercise their powers in the interest of the corporation and not in their own interest or in the interest of another entity or person. If a director has a conflict of interest, then that director should fully disclose all aspects of the conflict to the board.

State statutes generally contain a conflict of interest provision. In some state statutes, the conflict of interest rule may be altered or substituted based on provisions in the articles of incorporation or bylaws. MNCA §8.60 contains a fairly generous rule for conflicts of interest. A contract is not void or voidable because of a conflict of interest (and the interested director may even be present at or participating in the meeting of the board that authorizes the contract) if:

i. The conflict is disclosed and the board in good faith authorizes the contract by the affirmative votes of a majority of the disinterested directors (even though the disinterested directors are less than a quorum).

ii. The conflict is disclosed and the members specifically approve the contract; or

iii. The contract or transaction is fair to the corporation as of the time it is authorized, approved, or ratified by the board or the members.

Conflicts of interest that should be disclosed include:

i. Facilitating a transaction in an attempt to curry favor with the proponent of the transaction, other members of the board or members of management.

ii. Usurping corporate opportunities for the director's personal benefit; the organization must be given the first opportunity to take advantage of all opportunities within its line of business or in which the organization has an interest or a reasonable expectation of having an interest.

iii. Deriving an unfair or secret profit or commission from the director's position as a director at the expense of the organization.

iv. Receiving additional compensation or enhanced career prospects as a result of a transaction.

The IRS has a sample conflict of interest policy which requires much more than just disclosure. In general, under the IRS conflict of interest policy, if a conflict exists, the director must recuse himself/herself from not only the vote on the matter but also from the discussion (*i.e.*, leave the room). The IRS conflict of interest policy follows the requirements under the excess benefit rules.

Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, 381 F. Supp. 1003 (D.D.C 1974) is an example of the application of conflict of interest and investment diligence. The organization's directors had not attended meetings and had left large amounts in non-interest bearing accounts in a bank with which one of the directors was affiliated. The court set forth standards that are instructive. The court held that the director had violated his fiduciary duty to manage the fiscal and investment affairs if the evidence shows that (a) as a member of a board committee with general financial or investment responsibility, the director failed to use diligence in supervising the actions of those to whom day-to-day responsibilities for making financial or investment decisions has been delegated; (b) the director knowingly permitted the organization to enter into a transaction with himself, or a business with which he was associated, without having informed the organization of his interest or that the transaction might not be in the best interests of the organization; (c) except for such disclosure, the director actively participated in or voted in favor of such a transaction; or (d) the director otherwise failed to perform his duties honestly, in good faith and with a reasonable amount of diligence and care.

A director has a duty of confidentiality stemming from his duty of loyalty. A director should not disclose information about the entity's activities unless the information is already known by the public (or are of public record) or is required to do so under subpoena.

C. Duty of Obedience.

In addition to the duty of loyalty and the duty of care, the Board must comply with the organization's governing documents and make decisions in furtherance of its charitable purposes.

In contrast to stock corporations that have the clear purpose of profiting shareholders, ideas and standards about how a charitable organization should best advance its charitable mission are numerous and divergent. Even among experts, no agreed-upon answer exists and would be specific to each organization, in any case. Nevertheless, the Board must consider decisions under this standard.

Just as for the duty of care, the duty of obedience applies to the decision-making process and not to the ultimate decision. A director can make a decision that, in hindsight, was not the best one, or does not fit a third party's concept of furthering charitable purposes, but was still made with a good faith belief that the decision was in furtherance of the organization's charitable purposes.

If the conduct of the board of directors impairs rights of members set forth in the organization's documents, the members may bring a cause of action against the directors (similar to shareholders).

D. Standard of Care

A director must discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances. MNCA §8.30(b).

E. Best Judgment Rule

Generally, under the best judgment rule (the non-profit equivalent of the "business judgment rule"), the board's decisions will not be subject to judicial challenge if the decision was made on a fully informed basis, without self-interest, in good faith and in the honest belief that the decision was in furtherance of the organization's charitable purposes and within the scope of organization's governing documents. If its prerequisites are met, then the best judgment rule generally will protect directors against personal liability for decisions that turn out poorly.

If its prerequisites are not met, then the burden of proof generally shifts to the director to prove the "entire fairness" of his or her decision. To rebut the presumption of the applicability of the best judgment rule, the party challenging the decision generally must provide evidence that the director, in reaching the challenged decision, breached the duty of care, the duty of loyalty or the duty of obedience.

F. Standards of Liability for Directors

Under MNCA §8.31, a director is generally not liable to the nonprofit corporation or its members for any decision to take or not to take action, or any failure to take any action, as a director. The general exceptions are:

i. An action not in good faith; or

ii. A decision:

   a. which the director did not reasonably believe to be in the best interests of the corporation, or

   b. as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances; or

iii. A lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence due to the director's domination or control by, another person having a material interest in the challenged conduct:

   a. which relationship or which domination or control could reasonably be expected to have affected the director's judgment respecting the challenged conduct in a manner adverse to the corporation; and

   b. after a reasonable expectation to such effect has been established, the director has not established that the challenged conduct was reasonably believed by the director to be in the best interests of the corporation; or

iv. A sustained failure of the director to devote attention to ongoing oversight of the activities and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefor; or

v. Receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its members that is actionable under applicable law.

G. Directors' Liability for Unlawful Distributions / Loans

Directors are liable for unlawful distributions for the amount of the distribution that exceeds what could have been lawfully distributed if the director did not meet his duty of care and duty of loyalty under the MNCA. MNCA §8.33. Many state statutes simply prohibit directors from borrowing money from a non-stock corporation.

III. Indemnification

A. Mandatory Indemnification of Directors and Officers

A nonprofit corporation must indemnify a director or officer for his or her reasonable expenses incurred if the director or officer was successful in the defense of any proceeding to which the director or officer was a party because the director or officer was a director or officer of the corporation. MNCA §§ 8.52; 8.56.

B. Permitted or Obligatory Indemnification of Directors

The articles of incorporation can obligate the corporation to indemnify a director for liability to any person for any action taken, or any failure to take any action, as a director, except for liability for:

i. Receipt of a financial benefit to which the director is not entitled;

ii. An intentional infliction of harm;

iii. Unlawful distributions; or

iv. An intentional violation of criminal law. MNCA §2.02(b)(8).

C. Permissible Indemnification of Directors

A nonprofit corporation may indemnify a current or former director against liability incurred in the proceeding if the director:

i. Acted in good faith;

ii. Reasonably believed: (A) in the case of conduct in an official capacity, that the conduct was in the best interests of the corporation; and (B) in all other cases, that the individual's conduct was at least not opposed to the best interests of the corporation; and

iii. In the case of any criminal proceeding, had no reasonable cause to believe his or her conduct was unlawful.

However, a nonprofit corporation may not indemnify a director:

i. In connection with a proceeding by or in the right of the corporation, except for reasonable expenses incurred in connection with the proceeding if it is determined that the director has met the standard of conduct; or

ii. In connection with any proceeding with respect to conduct for which the director was adjudged liable on the basis that the director received a financial benefit to which the director was not entitled, whether or not involving action in an official capacity.

MNCA §8.51. In order to indemnify a director under MNCA §8.51, the board has to make a determination that the director has met the required standard. MNCA §8.55.

D. Indemnification of Officers

Officers are generally allowed the same indemnification as directors. The articles of incorporation, bylaws, or resolution of the board of directors may direct the nonprofit corporation to further indemnify the officers, except for any:

i. Liability in connection with a proceeding by or in the right of the corporation other than for reasonable expenses incurred in connection with the proceeding, or

ii. Liability arising out of conduct that constitutes:

   a. receipt by the officer of a financial benefit to which the officer is not entitled;

   b. an intentional infliction of harm on the corporation or the members; or

   c. an intentional violation of criminal law. MNCA §8.56.

E. Directors and Officers Liability Insurance (D&O Insurance).

Indemnification is not useful if the organization does not have the cash to pay the indemnification to the directors and officers. D&O insurance is a must. However, D&O insurance is more notable for what it does not insure than for what it does insure. Essentially, the typical policy covers fiduciary liability to the organization itself, i.e., loss of funds, rather than third-party liability for such things as personal injuries. Look carefully at the policy exclusions section to determine if you are receiving the desired coverage. D&O Insurance is desirable to make sure that some insurance company covers the costs of defense, which may exist even if no liability is established, to cover any indemnification obligations that the corporation may have to a sued director under its governing documents or state law, and to assist in the recruitment of directors.

A major issue for D&O insurance is covering private foundation excise taxes and "excess benefit" excise taxes. For excise taxes to be imposed on a director or officer, the individual must have acted knowingly, willfully and without reasonable cause. State insurance laws do not permit an insurance company to pay insurance for actions that were taken knowingly and in willful violation of the law. Therefore, if tax is imposed, the insurance company cannot pay the excise tax imposed on the officer or director. However, D&O insurance can pay the defense costs, regardless if the defense is successful or unsuccessful. For claims that are successfully defended or settled, insurance coverage is very valuable (although it may not pay the ultimate tax if one is imposed).

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