



By Mitch Dorger

In the Board Room

Legal Duties of a Board Member (Part II of Becoming a Board Member)

In my last column, I discussed what a board is responsible for and what its duties are. This issue, I will build on that foundation by describing the legal duties of a director.

In its excellent book, *Guidebook for Directors of Nonprofit Corporations*, the American Bar Association states that a director of a nonprofit organization owes the organization two duties: the Duty of Care and the Duty of Loyalty.

"The duty of care calls upon the director to act in a reasonable and informed manner when participating the board's decision and its oversight of the corporation's management." To meet this requirement the director must 1) stay informed of the affairs of the organization and 2) discharge duties in good faith, acting with the care that a reasonably prudent person in a like position would believe appropriate. (1:19)

The most basic requirement of the duty of care is to attend meetings. In general, the director himself or herself needs to be physically present at meetings and vote. Directors are not normally able to vote on matters by proxy as organization members might. Repeated absence from board meeting can expose the director to the risk of not fulfilling the duty of care to the organization. Many high-functioning boards establish attendance criteria that could result in the removal of a director if his or her attendance is shoddy. Attendance at committee meetings (which are an extension of the board) is included under this requirement and failure to attend committee meetings could result in sanctions of some type.

A second requirement of the duty of care is to exercise independent and informed judgment on organizational matters. Directors have a fiduciary re-

sponsibility to act in the best interests of the organization. No decisions should be made because a matter is recommended by the staff or even by the board chair. Each director must exercise his or her own judgment about what is the best for the organization. This responsibility even applies if the board member represents some particular group or interest on the board. The director's legal duty is to the organization as a whole and not to the group or interest they may be "representing" on the board.

Obviously, to carry out this responsibility, the board member must be properly informed. Normally, in an organization, information supplied to the board is prepared by the staff or by a committee working on behalf of the board. The director must individually evaluate whether this information is sufficient to make an informed decision. If he or she deems that it is not, he or she should ask for additional information. Do not hesitate to exercise this right as a new board member. Sometimes boards get complacent with the way things are going, and it takes a fresh set of eyes with a fresh perspective to see that board members are not receiving all they should in the form of information.

In hindsight, board decisions may turn out to be right or they may turn out to be wrong. The correctness of a decision is not that it creates a liability for the directors involved so long as they acted to

ensure they were properly informed and then acted in good faith and in a manner that they reasonably believed to be in the best interest of the organization. This is called the "Business Judgment Rule" and basically it says that courts may not second guess the judgment of the board "... if such director's action was undertaken in good faith, in a manner reasonably believed to be in the best interests of the corporation, and based on the director's independent and informed judgment." (1:28) This rule is well established in law and is one of the key protections that directors have.

Naturally, there are exceptions to any rule. In the case of the business judgment rule, it will not be applied where basic breaches of duty have occurred such as criminal activity, fraud, bad faith or willful and wanton misconduct. There is another special exception which might apply if the board chooses to cease the operations of a charitable organization. If this action is being contemplated by the board, the board should consult legal counsel before making any decision in this regard.

"The duty of loyalty requires directors to exercise their powers in good faith and in the best interests of the corporation, rather than in their own interests or the interests of another entity or person." (1:29) This duty applies to three areas: 1) conflicts of interest, 2) corporate opportunity, and 3) confidentiality.

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A conflict of interest occurs whenever a director has a material personal interest in a proposed contract or transaction to which the corporation may be a party. Importantly, such conflicts of interest are fairly common and certainly should not be considered unlawful or unethical. For example, a director may contract with the corporation for a service and provide that service at a substantial discount to the organization. This sort of arrangement makes good sense for all concerned, and the arrangement does not have to be terminated because a conflict of interest is occurring. What needs to happen is that the conflict needs to be fully disclosed and then reviewed and approved by the “disinterested” members of the board (or a designated committee of the board). “Disinterested” means that the director has no financial interest in the matter at hand. Normally, the board will ask itself 1) if the arrangement is indeed in the corporation’s best interest and 2) if it is fair to the corporation. In my last organization, we had a few of these occur each year with regard to professional services. A thorough review of the circumstances was made and in each case it was determined to be in the best interest of the corporation to continue the arrangements. This is perfectly appropriate. The key to preventing conflicts of interest is for the board to establish a system to allow full disclosure of the any conflicts and then have documented procedures in place to review the circumstances. Because this is a legal matter, I recommend organizations seek legal counsel in setting up procedures for identifying and handling conflicts of interest.

The area of the duty of loyalty is corporate opportunity. Corporate opportunity is fairly straightforward compared to the conflict of interest rules. Essentially, this rule states that if a director learns of a business opportunity which might reasonably be of interest to the corporation that he serves as a director for, then he must disclose the opportunity and allow the corporation to take advantage of it, before he pursues it on his own.

The third obligation under the duty of loyalty is confidentiality. Again, this obligation is fairly straightforward. A director should disclose information about the corporation’s activities outside of the board unless they are already known by the public or are of public record. High-performing boards might expand on this basic guidance by stating exactly what type of information may be revealed by board members and under what circumstances. But if there is any doubt, the director should maintain the confidentiality of board room information. Simple, right? Nothing could be further from

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the truth! In my experience, maintaining the confidentiality of the board is one of the hardest things to achieve. It seems in some organizations people view their status as determined by how much information they know and can leak to their friends. I used to sarcastically say that leaked information is often the “coin of the realm” in some organizations.

Someone might say, “What harm is done if the information is shared with members within the organization?” The answer is that a lack of confidentiality can absolutely cripple the effectiveness of a board. A board depends on the individual board members being able to candidly and frankly state their positions. If this information is leaked, what a person says in the confidence of a board room can come back to haunt him or her in a personal way. I have seen breaches of confidentiality take all candor out of board discussions and leave only cursory discussions within the confines of the board room. This can be devastating to the effectiveness of a board. Confidentiality must be preserved, even if that means sanctions against or even removal of the offending director.

There is one final element of the duty of loyalty that must be mentioned: if a director obtains knowledge of illegal or suspected illegal action within the organization, that director has an absolute requirement to disclose that information (regardless of whether the activity has been approved by the board). If suspicions exist, they must be revealed to the board chair or chief executive (or both) with a demand that the circumstances be investigated. If this fails to occur to the director’s satisfaction, the matter should be taken to the full board. If the suspicion is not repudiated, the director involved should clearly express his or her dissent and ensure that dissent is recorded. The director should also strongly consider consulting personal legal counsel.

That concludes the discussion of director duties. I recognize that the discussion

was long and there were simplifications made to try to be brief. I strongly recommend that every board have their legal counsel meet with the members of the board every few years to discuss these duties and ensure that all directors are aware of the legal nature of their duties to the board on which they serve.

In the next column, I will turn to the protections that directors have in carrying out their responsibilities.

Notes:

1. Committee on Nonprofit Corporations, Editors George W. Overton and Jeannie Carmedelle Frey, Guidebook for Directors of Nonprofit Corporations. Section of Business Law, American Bar Association, 2002.

Recently retired as the CEO of the Pasadena Tournament of Roses, Mitch Dorger brings to his new consulting practice more than 40 years of work experience including 20 years as a chief executive officer. His experience as a CEO was consistently characterized by successful performance improvement programs and high employee morale and achievement. He believes the fundamental goal of leadership is to inspire teamwork and the spirit of continuous improvement. He has recent expertise in the world of non-profit organizations and is well versed in corporate governance, volunteer management, financial planning and management, government relations, and large event management. As a public speaker he has lectured on non-profit organizational management, strategic planning, change management and leadership. He has also served as a keynote speaker for four different festival and event association conventions.

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