

Nonprofit Governance - California

A. Legal Duties of the Directors and Officers

Section 5210 of the California Corporations Code¹ (the “Code”) provides that subject to certain limitations relating to action required to be approved by members, “the activities and affairs of a corporation shall be conducted and corporate powers shall be exercised by or under the direction of the board. The board may delegate the management of the activities of the corporation to any person or persons, management company, or committee however composed, provided that the activities and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.”

Directors are subject to two fiduciary duties in carrying out their governance responsibilities: the duty of care and the duty of loyalty. Section 5231(a) of the Code codifies these duties, providing as follows:

A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(1) Duty of Care

Meeting a director’s duty of care generally requires acting in a reasonable and informed manner under the given circumstances. The standard of care is that which “an ordinarily prudent person in a like position would use under similar circumstances.”

A *prudent person* is “a generalist with the ability to select and evaluate senior officers, oversee and evaluate corporate performance, review and approve major corporate plans and actions, and perform other functions normally performed by for-

¹ Section 5210 of the Code applies to California nonprofit public benefit corporations. Substantially similar language applies to California nonprofit mutual benefit corporations. See Cal. Corp. Code §7210. Similar language also applies to California nonprofit religious corporations, but without express reference to limitations due to members’ rights and the permission to delegate to a management company or committee. See Cal. Corp. Code §9210. Although the general governance principles may be the same for all three types of California nonprofit corporations, there may be some other subtle differences. This Section II will hereinafter focus on California nonprofit public benefit corporations exempt under Section 501(c)(3) of the Internal Revenue Code (“IRC”) and recognized as public charities.

profit directors.”² A *like position* may take into account the size, type and complexity of the corporation. It may also factor in the director’s position as an inside or outside director. However, it is less likely that an individual director’s standard of care will be measured against the standard exhibited by other directors on the same board because cases imposing liability on a duty of care claim are often collective actions against the entire board.

Keeping informed (and making reasonable inquiries when appropriate) is a key to meeting a director’s duty of care. It may be prudent to consider the following activities as essential in that endeavor:

- Regularly attend board meetings.
- Assure that the directors receive adequate information before taking appropriate board action (e.g., by requesting materials and asking questions).
- Review the materials provided in connection with board meetings, particularly those used in reference to any contemplated board action.
- Be familiar with the organization, its legal structure, governing documents (e.g., articles of incorporation, bylaws), mission/exempt purposes (as represented in its governing documents, exemption applications and marketing materials), activities, and key stakeholders (including, but not limited to, staff).
- Be familiar with general laws applicable to the organization (including those covered in the following Section B).

Exercising independent judgment is another key to meeting a director’s duty of care. Voting with the majority or in the interest of another entity with which the director is affiliated without independent judgment about whether such action is in the corporation’s best interest may be a breach of the duty. Caution must also be given to simply voting with a director who has purported expertise in an area relevant to the decision. While it may be prudent to give such expert’s viewpoint strong weight, a director should consider other views before making an independent decision regarding the board action.

Reliance. Section 5231(b) of the Code generally provides that directors may rely upon information, opinions, reports, financial statements and other financial data prepared or presented by (1) corporate officers or employees; (2) counsel, independent accountants and others with professional or expert competence; or (3) board committees on which the director does not serve; provided, however, that: (a) the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances, and (b) the director reasonably believes that the provider of such information or opinion is competent and reliable with respect to, and authorized to provide, such information or opinion, and that such reliance is otherwise warranted.

Delegation. Section 5210 of the Code, discussed earlier, permits the board to delegate management of corporate activities. Indeed, boards generally delegate

² Haas, Jeffrey. When the endowment tanks. ABA Business Law Today, v.12, no. 5 (May/June 2003).

management of the day-to-day operations of a corporation to the corporate officers and management staff. However, while the board may delegate management of the corporation, it may not delegate its oversight responsibility nor its function to govern. See Kennerson v. Burbank Amusement Co., 120 Cal.App.2d 157, 173 (1953). Among the activities involved in adequate oversight:

- Prudent selection of officers and management staff.
- Selective and clearly defined delegations of authority.
- Adoption of monitoring policies and procedures to ensure legal compliance and prudent use of organizational resources.

Except as provided in Section 5233 of the Code (governing self-dealing transactions), a director who performs his or her duties in accordance with the standard of care as described in Section 5231(a) and (b) of the Code “shall have no liability based upon any alleged failure to discharge the person’s obligations as a director.”³ This provision is known as the business judgment rule and is based on the rationale that it would be improper for courts to second-guess corporate management decisions made in good faith and due care.⁴

(2) Duty of Loyalty

Meeting a director’s duty of loyalty generally requires acting in good faith and in the best interests of the corporation. The key to meeting this duty is to place the interests of the corporation before the director’s own interests or the interests of another person or entity.

Conflict of interest. A conflict of interest exists when a director has a personal material interest in a proposed transaction to which the corporation may be a party. Conflicts of interest are neither unusual nor generally prohibited. Indeed, transactions involving a conflict of interest may be in the best interest of the corporation. For example, it may be perfectly appropriate for a board to approve a transaction with a director in which the director is providing the corporation with some good, service or facility at below market rates.

From a legal perspective, it is the manner in which conflicts of interest (even ones that are favorable to the corporation) are handled by the director and the board that may

³ Code Section 5231(c).

⁴ Note, however, in Frances T. v. Village Green Owners Ass’n, 42 Cal.3d 490 (1986), the California Supreme Court opined that the business judgment rule applicable to directors of a California nonprofit mutual benefit corporation, codified in Section 7231 of the Code, is not a bar to a director’s personal liability to a third party injured by the director’s own tortious conduct, even if the director is acting on behalf of the corporation. In *Frances T.*, the Court determined that individual directors of a condominium association who negligently failed to authorize repairs to correct a hazardous condition could be held personally liable to the injured party based on their duty of care, independent of the corporation’s own duty, to refrain from acting in a manner which creates an unreasonable risk of personal injury to third parties. In response to this case, and the difficulty for many nonprofits to secure affordable insurance coverage, the California legislature enacted some statutory protections applicable to directors of certain nonprofit corporations. See Section II.C.4.

determine whether the director's duty of loyalty has been breached and whether the transaction may be rendered void. It should be noted, however, that transactions involving even a perceived conflict of interest may subject the interested director and the corporation to a serious loss in reputation. Accordingly, corporations should enter into such transactions cautiously where the directors believe that it could be viewed negatively if brought to light by the media. For all these reasons, a conflict of interest policy is highly recommended.

A conflict of interest may exist in the following examples:

- Employment or independent contractor agreement between the corporation and a director or a member of the director's family⁵.
- Provision of a good, service or use of a facility to a director, a member of the director's family or an entity affiliated with a director.
- Provision to the corporation of a good, service or use of a facility by a director, a member of the director's family or an entity affiliated with a director.
- Decision to engage in a transaction or activity that may otherwise benefit or harm a director's personal interests.
- "Self-dealing transactions" as defined in state law.
- "Excess benefit transactions" as defined in federal tax law.

Self-dealing transactions. Section 5233(a) of the Code defines a *self-dealing transaction* as "a transaction to which the corporation is a party and in which one or more of its directors has a material financial interest and which does not meet the requirements of paragraph (1), (2), or (3) of subdivision (d)."⁶ Where a self-dealing transaction has taken place, a court may order the interested directors to take certain actions and pay damages as in the discretion of the court will provide an equitable and fair remedy to the corporation. Cal. Corp. Code §5233(h).

The Section 5233(d)(1) exception requires the Attorney General or a court to approve the transaction before or after it was consummated.

The Section 5233(d)(2) exception requires that all of the following facts be established:

- (A) The corporation entered into the transaction for its own benefit;
- (B) The transaction was fair and reasonable as to the corporation at the time it entered into the transaction;

⁵ Note that Section 5227 of the Code provides that not more than 49% of the board of a California public benefit corporation may be composed of "interested directors" as defined by Section 5227 (including any person currently being compensated by the corporation for services rendered to it within the previous 12 months (excluding any reasonable compensation paid to a director for serving as a director) and certain members of such person's family).

⁶ The definition of self-dealing under Section 5233 of the Code should not be confused with the definition of self-dealing under IRC Section 4941, which is applicable to private foundations. Notably, the statutory exceptions to Section 5233 do not expressly apply to IRC Section 4941.

- (C) Prior to consummating the transaction or any part thereof the board authorized or approved the transaction in good faith by a vote of a majority of the directors then in office without counting the vote of the interested director or directors, and with knowledge of the material facts concerning the transaction and the director's interest in the transaction; and
- (D) Prior to authorizing or approving the transaction the board considered and in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances or (ii) the corporation in fact could not have obtained a more advantageous arrangement with reasonable effort under the circumstances

The Section 5233(d)(3) exception requires that all of the following facts be established:

- (A) A committee or person authorized by the board approved the transaction in a manner consistent with the standards set forth in Section 5233(d)(2);
- (B) It was not reasonably practicable to obtain approval of the board prior to entering into the transaction; and
- (C) The board, after determining in good faith that the conditions of Section 5233(d)(3)(A) and (B) were satisfied, ratified the transaction at its next meeting by a vote of the majority of the directors then in office without counting the vote of the interested director or directors.

Excess Benefit Transactions. Section 4958(c)(1)(A) of the IRC defines an *excess benefit transaction* as “any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person⁷ if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.” An excess benefit transaction involving a director is an example of self-dealing and a conflict of interest. Moreover, any excess benefit transaction is prohibited and may subject the disqualified person and the directors who knowingly approved such transaction to significant federal excise taxes. IRC §4958(a), (b).

Corporate opportunity. The corporate opportunity doctrine “prohibits one who occupies a fiduciary relationship to a corporation from acquiring, in opposition to the corporation, property in which the corporation has an interest or tangible expectancy or which is essential to its existence.” Kelegian v. Mgrdichian, 33 Cal.App.4th 982, 988 (1995). A corporate opportunity exists “when a proposed activity is reasonably incident to the corporation’s present or prospective business and is one in which the corporation has capacity to engage.” Id. Accordingly, a director who learns of a prospective transaction that might be considered a corporate opportunity may find it prudent to first present the opportunity to the board and allow the corporation sufficient time and first

⁷ A *disqualified person* with respect to a transaction is “(A) any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization [including directors of the corporation], (B) a member of the family of an individual described in subparagraph (A), and (C) a 35-percent controlled entity.” IRC §4958(f)(1).

right to exploit the opportunity before taking advantage of the transaction outside of his or her capacity as a director.

Confidentiality. A director should keep the corporation's private information confidential. In addition, a director should exercise reasonable diligence to keep such information confidential. Note that the strategic plans of a corporation may contain confidential information not meant to be disclosed to the general public lest some other person or entity be able to exploit the information to the disadvantage of the corporation.

(3) Duty of Obedience

Meeting a director's duty of obedience generally requires adherence to all applicable laws and the governing documents of the corporation, including acting in furtherance of the corporation's mission.

B. Legal Requirements Affecting the Organization

(1) Section 501(c)(3) Requirements

Organizations described by Section 501(c)(3) of the Internal Revenue Code of 1986, as amended ("IRC"), and tax-exempt under IRC Section 501(a) are defined as:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

The Organizational Test. The Organizational Test provides that a 501(c)(3) organization must be organized exclusively for one or more of the exempt purposes set forth in Section 501(c)(3).⁸ This test is satisfied if the organization's governing documents meet certain requirements, including limitation of the organization's purpose, and dedication of its assets, to one or more exempt purposes.⁹

The Operational Test. The Operational Test provides that a 501(c)(3) organization must be operated *primarily* for one or more of the exempt purposes set forth

⁸ Treas. Reg. §1.501(c)(3)-1(a)(1).

⁹ Treas. Reg. §1.501(c)(3)-1(b).

in Section 501(c)(3).¹⁰ Only an "insubstantial part" of the organization's activities may be devoted to non-exempt purposes, such as operating an unrelated business.¹¹ If, however, the organization's primary purpose is the operation of an unrelated trade or business, it may not qualify for 501(c)(3) exempt status, even if all of the profits from such trade or business are to be used in furtherance of its exempt purposes.

No Private Inurement. No part of the organization's net earnings may inure to the benefit of any private shareholder or individual. The private inurement doctrine generally prohibits an exempt organization from using its assets for the benefit of a person having a personal and private interest in the organization's activities (i.e., an insider such as a director, officer or key employee). An organization that engages in an inurement transaction (e.g., paying an unreasonable compensation to an insider) may face revocation of its exempt status.

No Private Benefit. An organization will similarly fail the Operational Test unless it serves a public rather than a private interest.¹² To satisfy this requirement, referred to as the private benefit doctrine, the organization must establish that it is not operated for the benefit of private interests. This does not mean that the organization may not confer benefits to individuals; rather, it provides that such benefits must be incidental, quantitatively and qualitatively, to the furthering of the organization's exempt purposes.¹³ While the private benefit and private inurement doctrines appear very similar, there are two important differences. One, the private benefit doctrine is much broader than, and indeed subsumes, the private inurement doctrine because it applies whenever an impermissible benefit is being conferred on any private party, not just insiders. Two, unlike the case with private inurement, an incidental amount of private benefit may not cause a loss or denial of exempt status. Instead, excise taxes, referred to as intermediate sanctions, may be imposed on *excess benefit transactions* between Section 501(c)(3) public charities and *disqualified persons*.¹⁴ The IRS takes the position that it may both revoke an organization's exempt status and apply intermediate sanctions to the disqualified persons and any organizational managers who knowingly approved a prohibited private inurement transaction.

Excess Benefit Transactions. Federal tax laws also prohibit certain transactions characterized by a conflict of interest. IRC Section 4958(c)(1)(A), which applies to organizations exempt under either IRC Section 501(c)(3) or 501(c)(4) that are not private

¹⁰ Treas. Reg. §1.501(c)(2)-1(c)(1).

¹¹ *See id.*

¹² Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).

¹³ Gen. Couns. Mem. 39862, Nov. 21, 1991.

¹⁴ IRC §4958. In this context, a *disqualified person* is (A) any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization; (B) a member of the family of an individual described in (A), and (C) a 35-percent controlled entity (an entity in which persons described in (A) or (B) own more than 35 percent of the total controlled voting power (corporations), profits interest (partnerships) or beneficial interest (trusts and estates)). An *excess benefit transaction* is any transaction in which an economic benefit is provided by the applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided by the exempt organization exceeds the value of the consideration (including the performance of services) received for providing the benefit.

foundations, defines an *excess benefit transaction* as “any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person¹⁵ if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.” An excess benefit transaction involving a director is an example of self-dealing and a conflict of interest. Moreover, any excess benefit transaction is prohibited and may subject the disqualified person and the directors who knowingly approved such transaction to significant federal excise taxes (“intermediate sanctions”).¹⁶

No Substantial Lobbying. In general, no organization may qualify for Section 501(c)(3) status if a substantial part of its activities is attempting to influence legislation (commonly known as lobbying). A 501(c)(3) organization may engage in some lobbying, but too much lobbying activity risks loss of tax-exempt status. Legislation includes action by Congress, any state legislature, any local council, or similar governing body, with respect to acts, bills, resolutions, or similar items (such as legislative confirmation of appointive office), or by the public in referendum, ballot initiative, constitutional amendment, or similar procedure. It does not include actions by executive, judicial, or administrative bodies. An organization will be regarded as attempting to influence legislation if it contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or if the organization advocates the adoption or rejection of legislation. Organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, organizations may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

No Electioneering. All Section 501(c)(3) organizations are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective office. Contributions to political campaign funds or public statements of position (verbal or written) made on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate this prohibition. Such violation may result in denial or revocation of tax-exempt status and the imposition of certain excise tax. Note, however, that certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, certain voter education activities (including the presentation of public forums and the publication of voter education guides) and certain other activities intended to encourage people to participate in the electoral process (e.g., voter registration and get-out-the-vote drives), if conducted in a non-partisan manner, do not constitute prohibited political campaign activity.

¹⁵ A *disqualified person* with respect to a transaction is “(A) any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization [including directors of the corporation], (B) a member of the family of an individual described in subparagraph (A), and (C) a 35-percent controlled entity.” IRC §4958(f)(1).

¹⁶ IRC §4958(a), (b).

(2) Charitable Trust Requirements

Charities may recognize the charitable trust doctrine as it applies to gifts explicitly restricted to certain uses by the donor (i.e., restricted gifts). The doctrine provides that such gifts, if accepted, would be subject to any valid legal restrictions imposed by the donor at the time of the contribution. In California, however, the charitable trust doctrine has much broader application, including where the donor does not explicitly impose any restriction on the gift.¹⁷ In essence, there may be no such thing as an unrestricted gift.

The charitable trust doctrine has developed in California to encompass the circumstance where a charitable corporation changes its charitable purposes. The doctrine provides that under such circumstance, the unrestricted gifts that the charity received prior to the change in charitable purposes must be used for only the declared charitable purposes at the time the gifts were accepted. The rationale behind the doctrine is that a donor made a gift to the charity in reliance that such gift would be used exclusively to further the charity's public representation of its charitable purposes. A charity may publicly represent its charitable purposes in its articles of incorporation, bylaws, exemption applications (i.e., IRS Form 1023 and CA Form 3500), information returns (e.g., Form 990), fundraising materials, and dominant activities.

Even revenues from sources other than charitable gifts and donations may be subject to the charitable trust doctrine.¹⁸ Some commentators base this expansion of the doctrine on the following premises: (1) the charity's gifted and non-gifted assets are typically commingled, and (2) the gifted assets supplied the initial capital that enabled the charity to acquire or earn the non-gifted assets.

The charitable trust requirement may be breached where the assets imposed with a charitable trust are diverted to compensate an individual who the charity has no legal obligation to pay.¹⁹ A possible example of such improper diversion may be the payment of bonuses to employees without a preexisting agreement that provides for the possibility of such compensation.

An exception to the requirements imposed by the charitable trust laws applies where the declared charitable purpose of the charity becomes illegal, impossible or impracticable to carry out. In such event, the *cy pres* doctrine requires that the assets imposed with a charitable trust be used to further a charitable purpose that reasonably approximates the original declared charitable purpose.

¹⁷ See In Pacific Home v. County of Los Angeles, 41 Cal.2d 844, 852 (1953). In Pacific Home, the Supreme Court pronounced: "All the assets of a corporation organized solely for charitable purposes must be deemed to be impressed with a charitable trust by virtue of the express declaration of the corporation's purposes, and notwithstanding the absence of any express declaration by those who contribute such assets as to the purpose for which the contributions are made. In other words, the acceptance of such assets under these circumstances establishes a charitable trust for the declared corporate purposes as effectively as though the assets had been accepted from a donor who had expressly provided in the instrument evidencing the gift that it was to be held in trust solely for such charitable purposes."

¹⁸ See Queen of Angels Hospital v. Younger, 667 Cal.App.3d 359 (1977).

¹⁹ Id. at 371.

(3) Charitable Solicitation Requirements

See California Business and Professions Code Sections 17510-17510.95. See also the attached memo on the Nonprofit Integrity Act.

Boards should also consider the charitable solicitation laws of each jurisdiction in which the organization solicits contributions²⁰.

(4) Substantiation and Disclosure Requirements

There are two general rules that organizations should be aware of regarding substantiation and disclosure requirements for federal income tax return reporting purposes²¹:

- A donor is responsible for obtaining a written acknowledgment from a charity for any single contribution of \$250 or more before the donor can claim a charitable contribution on his/her federal income tax return.
- A charitable organization is required to provide a written disclosure to a donor who receives goods or services in exchange for a single payment in excess of \$75.

Charities should also be aware that, effective January 1, 2007, a donor cannot claim a charitable deduction for any contribution unless the donor maintains a record of such contribution (e.g., a bank record or cancelled check; or written communication from the charity showing the name of the charity and the date and amount of the contribution).²²

Organizations that dispose of charitable deduction property (property other than cash or certain publicly traded securities) within 2 years of the contribution date must file IRS Form 8282 within 125 days after the date of disposition unless: (1) at the time the donee charity signed the donor's Appraisal Summary (Section B of Form 8283, Noncash Charitable Contributions), the donor signed a statement on the Form that the appraised value of the specific item was not more than \$500; or (2) the item is consumed or distributed, without consideration, in fulfilling the donee charity's exempt purpose or function.

(5) Requirements Associated With Other Activities

Although beyond the scope of this program, consider your need to be familiar with legal requirements associated with:

- Hiring, managing and terminating employees.

²⁰ State and local laws may apply with respect to charitable solicitations. For additional information about the registration requirements of other states, see the website of "The Unified Registration Statement" at www.multistatefiling.org.

²¹ More information about disclosure and substantiation requirements may be found in IRS Publication 1771.

²² Pension Protection Act of 2006.

- Managing volunteers.
- Managing organizational assets (including endowment funds).²³
- Unrelated business activities.
- Commercial e-mail practices.²⁴
- Managing and/or owning real property.
- International charity.
- Participating in coalitions and joint ventures.
- Entering into a merger with another entity.
- Entering into the zone of insolvency/bankruptcy.

C. Protections from Liability

(1) Directors' Exposure to Liability

While directors may be protected by the limited liability associated with a corporation, directors should be aware of several areas in which they may be subject to personal liability:

- Breach of the directors' fiduciary duties.
- Breach of charitable trust.
- Self-dealing transaction by an interested director.
- Excess benefit transaction (e.g., excessive compensation).
- Wrongful actions taken outside of the director's scope of authority.
- Employment claims (e.g., discrimination, sexual harassment, wrongful termination) against responsible directors.
- Discrimination claims by beneficiaries of the charity (e.g., for wrongfully denied benefits) against responsible directors.
- Other claims (e.g., for torts causing personal injury, breach of contract, defamation, intellectual property infringement, professional misconduct) against responsible directors.
- Failure to pay payroll taxes claim against responsible persons.
- Failure to observe corporate formalities (e.g., commingling personal and organizational assets, failure to hold or record minutes of meetings, failure to appoint or elect directors and officers).

The best protection for a director to avoid personal liability is to meet his or her fiduciary duties, acting with due care and loyalty. Additional protections are discussed below.

(2) Indemnification

Section 5238 of the Code provides for the indemnification of *agents* (including past and present directors, officers and employees) by a nonprofit corporation. Indemnification, in this context, means that the corporation will reimburse a person for

²³ See, e.g., Uniform Prudent Investor Act; Uniform Management of Institutional Funds Act.

²⁴ See CAN-SPAM Act of 2003.

any expenses (including attorneys' fees), judgments, fines, settlements and other amounts actually and reasonably incurred in connection with a *proceeding* (threatened, pending or completed, whether civil, criminal, administrative or investigative) against such person by reason of the fact such person is or was an agent of the corporation.

In any proceeding, the corporation must indemnify the agent to the extent that the agent has been successful on the merits in any proceeding and any claim, issue or matter therein.

In a proceeding other than an action (i) by or in the right of the corporation, (ii) brought under Section 5233 of the Code (for self-dealing), or (iii) brought by the Attorney General (or person granted relator status):

- The corporation may indemnify the agent, where the agent has not been successful on the merits in a proceeding (e.g., judgment against agent or settlement), upon a determination by the board (majority vote of a quorum consisting of directors who are not parties to the proceeding), the members (not including those to be indemnified) or the court that the agent "acted in good faith and in a manner such person reasonably believed to be in the best interests of the corporation and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct of such person was unlawful"²⁵ (a "Good Faith Determination").
- The corporation may be prohibited from indemnifying the agent if the determination by the board or members is contrary to the holding of the proceeding. At the very least, it may be difficult to justify such determination under most circumstances.

In an action (i) by or in the right of the corporation, (ii) brought under Section 5233 of the Code (for self-dealing), or (iii) brought by the Attorney General (or person granted relator status):

- The corporation may indemnify the agent for expenses incurred in defending a threatened or pending action which is settled upon a Good Faith Determination so long as the settlement is approved by the Attorney General.
- The corporation is prohibited from indemnifying the agent for the following: (i) a claim, issue or matter as to which the agent was held to be liable by the court (unless and only to the extent that the court determines that the agent is fairly and reasonably entitled to indemnity for the expenses (but not the judgment)); (ii) amounts paid in settling or disposing of a threatened or pending action; and (iii) expenses incurred in defending a threatened or pending action which is settled without the Attorney General's approval.

The board of a nonprofit corporation may find it prudent to provide for the extent of indemnification desired in the corporation's bylaws. Indemnification provisions that

²⁵ See Code §5238(b), (e).

are permissive in the Code but made mandatory in the bylaws may help in the recruitment and retention of qualified directors.

(3) Insurance

Nonprofit organizations should assess their insurance needs by consulting with a qualified insurance broker. Insurance products may vary widely in terms of coverage and cost among different insurance companies. The following information provides some very basic information about some of the insurance products available to nonprofits.

Commercial General Liability. The Commercial General Liability (“CGL”) insurance policy typically provides broad liability coverage to the insured (i.e., the nonprofit corporation) for acts by the insured causing bodily injury, personal injury, property damage or advertising injury²⁶ to a third party. CGL policies may provide coverage on either a claims made or occurrence basis.

Claims made policies require the *claims* to be made within the policy period (i.e., while the policy is in force). They may or may not provide coverage for *acts* occurring prior to the policy period. Generally, an insured nonprofit may prefer to have continuous coverage since its formation that will cover all acts no matter when the claims are made. For this reason, it may be prudent to ensure that a claims made policy has “full prior acts” coverage with no retroactive date as to how long ago the prior act may have taken place. Moreover, it may be critically important that the insured immediately notify the insurance company if it learns of a situation that could lead to a claim or receives notice of a claim. If the insured notifies the insurance company a day after the policy expires, it may not be covered. To address such problem, it may be prudent to purchase an Extended Reporting Period (or “tail”) which extends the claims reporting provisions of the policy for a specific time period. An Extended Reporting Period may be of particular value if the insured switches from a claims made to an occurrence policy.

Occurrence policies provide coverage for acts occurring within the policy period even if the claims arising out of such acts are filed after the policy period terminates. Generally, occurrence policies are preferred by nonprofits over claims made policies without prior acts coverage even though the occurrence policies may be more expensive.

Directors and Officers Liability. The Directors and Officers Liability (“D&O”) insurance policy typically provides coverage of damages resulting from the wrongful acts of directors and officers (and possibly other volunteers and agents of the corporation), including wrongful decisions and actions of the board. D&O policies are different from, and complementary to, CGL policies (e.g., D&O policies generally do not cover bodily injury or property damage resulting from negligence). Rather, they may cover claims

²⁶ Advertising injury is generally defined as an injury arising out of libel, slander, disparagement, violation of the right of privacy, misappropriation of advertising ideas or style of doing business, or infringement of copyright, title or slogan. Advertising injuries are caused by an offense committed in the course of advertising the insured’s goods, products or services (e.g., through marketing materials, oral presentations, written publications and websites).

such as employment-related actions (e.g., discrimination, harassment, wrongful termination) and mismanagement of assets.

D&O insurance may serve not only to provide important protection to the directors, officers and volunteers of the nonprofit, but also to help in the recruitment and retention of such individuals. Many persons with qualifications and experience valuable to a nonprofit will not serve on a board without requiring that the organization maintain adequate D&O coverage.

Other Insurance Products.

- Property coverage.
- Non-owned auto coverage.
- Business-owned auto coverage.
- Professional liability (errors and omissions) coverage.
- Workers' compensation coverage (mandatory for employers).
- Improper sexual conduct coverage.
- Employee benefits liability coverage.
- Employee fidelity/dishonesty coverage.
- Student/volunteer/participant accident (no-fault) coverage.
- Liquor liability coverage.
- Umbrella coverage.

(4) Statutory Protections

Various California statutes and a federal statute have been passed to protect directors of nonprofit corporations. However, directors should not rely upon these statutory protections as they each contain several possible exceptions, exclusions and qualifications, and a competent plaintiff's attorney may be able to easily plead around such protections.

Section 5047.5. Section 5047.5(b) of the Code, which applies only to nonprofit corporations that are exempt under either Section 501(c)(3) or Section 501(c)(6) of the IRC, provides in pertinent part:

Except as provided in this section, no cause of action for monetary damages shall arise against any person serving without compensation as a director or officer of a nonprofit corporation ... on account of any negligent act or omission occurring (1) within the scope of that person's duties as a director acting as a board member, or within the scope of that person's duties as an officer acting in an official capacity; (2) in good faith; (3) in a manner that the person believes to be in the best interest of the corporation; and (4) is in the exercise of his or her policymaking judgment.

The statutory protection of Section 5047.5 will not limit the liability of a director or officer for such actions as the following:

- Self-dealing transactions, as described in Code Sections 5233 (applicable to nonprofit public benefit corporations) and 9243 (applicable to nonprofit religious corporations).
- Conflicts of interest, as described in Code Section 7233 (applicable to nonprofit mutual benefit corporations).
- Any action or proceeding brought by the Attorney General.
- Intentional, wanton, or reckless acts, gross negligence, or an action based on fraud, oppression, or malice.

Moreover, Section 5047.5 applies only if:

- The nonprofit corporation maintains a general liability insurance policy with an amount of coverage of at least the following amounts:
 - If the corporation's annual budget is less than \$50,000, the minimum required amount is \$500,000.
 - If the corporation's annual budget equals or exceeds \$50,000, the minimum required amount is \$1 million.
- The claim against the director or officer may also be made directly against the corporation and a general liability is in force both at the time of the injury and at the time the claim against the corporation is made, so that a policy is applicable to the claim.
- The volunteer director or officer does not receive compensation from the corporation in any capacity, including as an employee (not including the payment of actual expenses incurred in attending meetings or otherwise in the execution of the duties of a director or officer).

The required standard of care described in Section 5047.5(b) does not explicitly provide for the ability to rely upon the information and opinion of third parties. Accordingly, directors or officers who relied upon the information or opinion of an officer, employee, counsel, accountant or board committee may find that Section 5047.5 does not provide a defense to a plaintiff's claim against them.

Section 5239. Section 5239 of the Code, which applies to California nonprofit public benefit corporations, provides in pertinent part:

There shall be no personal liability to a third party for monetary damages on the part of a volunteer director or volunteer executive officer of a nonprofit [public benefit] corporation . . . , caused by the director's or officer's negligent act or omission the performance of that person's duties as a director or officer, if all of the following conditions are met:

- (1) The act or omission was within the scope of the director's or executive officer's duties.

- (2) The act or omission was performed in good faith.
- (3) The act or omission was not reckless, wanton, intentional, or grossly negligent.
- (4) Damages caused by the act or omission are covered pursuant to a liability insurance policy issued to the corporation, either in the form of a general liability policy or a director's and officer's liability policy, or personally to the director or executive officer. In the event that the damages are not covered by a liability insurance policy, the volunteer director or volunteer executive officer shall not be personally liable for the damages if the board of directors of the corporation and the person had made all reasonable efforts in good faith to obtain available liability insurance.²⁷

The protection of Section 5239 does not extend to compensated directors and officers nor to the liability of a volunteer director or officer (i) for self-dealing (Section 5233), (ii) for an act or omission described in Section 5237 (including illegal distributions and impermissible loans to directors or officers without the Attorney General's approval), or (iii) in any action or proceeding brought by the Attorney General. Moreover, if the required liability insurance policy fails to cover all of the damages, it is unclear whether Section 5239 would shield the volunteer director or officer from the damages in excess of those covered by the policy.

Code of Civil Procedure Section 425.15. Section 425.15 of the California Code of Civil Procedure ("CCP") does not apply to directors and officers of organizations exempt under IRC Section 501(c)(3). Rather, it applies only to uncompensated directors and officers of nonprofit corporations (i) that are exempt from federal income taxation under IRC Sections 501(c)(1) (except credit unions), 501(c)(5) (labor unions), 501(c)(7) (social clubs), or 501(c)(19) (veterans organizations); (ii) that are "organized to provide charitable, educational, scientific, social, or other forms of public service;" and (iii) that do not unlawfully restrict membership, services or benefits conferred.

CCP Section 425.15 provides in pertinent part:

No cause of action against a person serving without compensation as a director or officer of a nonprofit corporation described in this section, on account of any negligent act or omission by that person within the scope of

²⁷ Section 5239(h) of the Code provides that as applied to nonprofit public benefit corporations which have an annual budget of less than \$25,000 and that are exempt from federal income taxation under IRC Section 501(c)(3), the condition of making "all reasonable efforts in good faith to obtain available liability insurance" shall be satisfied by the corporation if it makes at least one inquiry per year to purchase a general liability insurance policy (with at least \$500,000 of coverage) and that insurance was not available at a cost of less than 5% of the previous year's annual budget of the corporation. If the corporation is in its first year of operation, the foregoing shall apply for as long as the budget of the corporation does not exceed \$25,000 in its first year of operation.

that person's duties as a director acting in the capacity of a board member, or as an officer acting in the capacity of, and within the scope of the duties of, an officer, shall be included in a complaint or other pleading unless the court enters an order allowing the pleading that includes that claim to be filed after the court determines that the party seeking to file the pleading has established evidence that substantiates the claim.

Accordingly, a pleading may contain a negligence cause of action against such director or officer only after a court determines that evidence has been established by the party seeking to file such pleading (through a verified petition and supporting affidavits) to substantiate the claim. The purported rationale behind this “pleading hurdle” was to screen out frivolous lawsuits against the described directors or officers.

Volunteer Protection Act. The federal Volunteer Protection Act of 1997, which generally applies to volunteers of (i) nonprofit organizations described in 501(c)(3) of the Internal Revenue Code, (ii) other nonprofit public benefit organizations operated primarily for charitable, civic, educational, religious, welfare, or health purposes, and (iii) government entities, provides certain limitations on liability of such volunteers. A volunteer under the Act is “an individual performing services for a nonprofit organization or a governmental entity who does not receive – (A) compensation (other than reasonable reimbursement or allowance for expenses actually incurred); or (B) any other thing of value in lieu of compensation, in excess of \$500 per year, and such term includes a volunteer serving as a director, officer, trustee, or direct service volunteer.”

Except as otherwise provided in the Act, a volunteer shall not be liable for harm caused by an act or omission of the volunteer on behalf of the organization if:

- The volunteer was acting within the scope of the volunteer’s responsibilities in the organization or entity at the time of the act or omission;
- If appropriate or required, the volunteer was properly licensed, certified, or authorized by the appropriate authorities in the state for the activities taken;
- The harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer; and
- The harm was not caused by the volunteer operating a motor vehicle, vessel, aircraft or other vehicle requiring an operator’s license or insurance.

The limitations on the liability of a volunteer under the Act shall not apply to misconduct that:

- Constitutes a crime of violence or act of international terrorism for which the defendant has been convicted;
- Constitutes a hate crime;
- Involves a sexual offense for which the defendant has been convicted;

- Involves misconduct for which the defendant has been found to have violated a federal or state civil rights law; or
- Where the defendant was under the influence of alcohol or any drug at the time of the misconduct.

Where a volunteer acts within the scope of the volunteer's responsibilities, but otherwise does not meet the criteria for a complete defense against liability, the volunteer's liability shall be limited by the Act as follows:

- Punitive damages may not be awarded against such volunteer unless the claimant establishes by clear and convincing evidence that the harm was proximately caused by an action of such volunteer which constitutes willful or criminal misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed.
- The volunteer's liability for noneconomic loss (e.g., loss for physical and emotional pain, suffering, inconvenience, physical impairment, mental anguish, disfigurement, loss of enjoyment of life, loss of society and companionship, loss of consortium, injury to reputation) shall be limited to the amount of noneconomic loss allocated to the volunteer in direct proportion to the percentage of responsibility of that defendant for the harm.

While the Act may provide a complete defense to an action against a volunteer under certain conditions, it should be noted that the Act does not prohibit a lawsuit against a volunteer. Accordingly, the Act may offer little protection to a volunteer from the potentially substantial monetary and personal costs of defending a claim.

D. Nonprofit Integrity Act

See the memo available on Nonprofit Law Blog.²⁸

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This memorandum is intended to provide accurate information with respect to its subject matter. It does not constitute legal or professional advice, and it is not an invitation for an attorney-client relationship. If specific legal advice is sought, the reader is advised to retain the services of a competent professional.

²⁸ http://www.nonprofitlawblog.com/home/files/the_nonprofit_integrity_act_of_2004_v.3.pdf.