AVOIDING THE RED CARD:
STANDARDS OF CONDUCT OF DECISION MAKERS

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STANDARDS OF CARE OF DECISION MAKERS

I. INTRODUCTION

Serving as a decision maker in a business enterprise carries an unavoidable element of risk whether the organization operates for profit or as a nonprofit. Within the nonprofit realm, and more particularly for purposes of the present discussion, within the realm of tax-exempt nonprofits, decision makers (often referred to as managers) must look to both state and federal law to identify the standards to which they will be held. This paper proposes to highlight the standards to which decision makers of nonprofit entities organized under Texas law are held under both state law as well as federal tax law thereby identifying the restraints on decision makers in the performance of their duties. In providing such information, the goal of the paper is to identify the proverbial rules of the game, thereby providing decision makers the ability to govern their conduct to avoid penalties both to themselves as well as to the organizations which they serve.

II. STATE STANDARDS OF CONDUCT

A. What Law Applies

The choice of legal form begins the analysis of what standards apply. In general, nonprofit organizations, particularly those seeking to qualify as exempt from federal income tax under § 501(c)(3) of the Internal Revenue Code (the “Code”), fall into one of three categories: (1) the charitable trust; (2) the nonprofit corporation; or (3) the nonprofit unincorporated association.

A charitable trust is a fiduciary relationship with respect to property whereby property is held in trust for charitable purposes. Texas law defines a charitable trust as “a charitable entity, a trust the stated purpose of which is to benefit a charitable entity, or an inter vivos or testamentary gift to a charitable entity.” TEX. TRUST CODE § 123.001(2). Charitable trusts are the oldest type of nonprofit entity tracing their roots back to the Statute of Charitable Uses of 1601. 43 Elizabeth, Chapter 4 (England 1601). A charitable trust is created by a settler irrevocably transferring property to a person or entity as trustee with the intention of creating a trust. Under Texas law, charitable trusts are directed by one or more trustees. Charitable trusts are governed by the Texas Trust Code which includes provisions specifically addressed to charitable trusts. See TEX. TRUST CODE § 123.001 et seq. In addition, a large body of common law exists in the area of charitable trusts.

Texas law defines a nonprofit corporation as a corporation whose income may not be distributed to its members, directors, or officers in the form of dividends or otherwise. See Tex. Rev. Civ. Stat. art. 1396-1.02(3); BOC § 22.001(5). Nonprofit corporations may be member organizations or non-member organizations but are generally governed by a board of directors with a minimum of three directors. Only those directors with a right to vote are subject to the statutory duties and liabilities of a director under Texas law. See Tex. Rev. Civ. Stat. art. 1396-2.14F; BOC § 22.210. Texas law provides that nonprofit corporations may be governed by its members though such governance is rare outside of congregationally-led religious organizations.

Nonprofit corporations in existence prior to January 1, 2006 will continue to be governed by the Texas Non-Profit Corporation Act until January 1, 2010 unless they have opted into the Texas Business Organizations Code. Nonprofit Corporations formed after January 1, 2006 or later are governed by the provisions of the Business Organizations Code.

Nonprofit unincorporated associations are essentially a default nonprofit organization. Texas law defines a nonprofit unincorporated association as an unincorporated association, other than one created by trust, consisting of three or more members joined by mutual consent for a common, nonprofit purpose. See Tex. Rev. Civ. Stat. art. 1396-70.01(2); BOC § 252.001(2). Formation of an unincorporated association is not governed by statute and does not require any organizational documents although an unincorporated association will typically have articles of association, a constitution, bylaws, or some other form of governing document. Where the unincorporated association intends to apply for recognition of exempt status under § 501(c)(3), the entity will have some sort of governing document to ensure it is governed by the requisite provisions to be entitled to recognition of exempt status, e.g., provisions regarding organization, operation and dissolution. The unincorporated association may be governed by its members or by managers though Texas law lacks definition in this area. Decision
makers of associations would appear to be more analogous to directors of corporations than trustees. However, because the law is unclear, it is most prudent for such decision makers to follow the stricter trustee standards with respect to their fiduciary duties.

As with nonprofit corporations, unincorporated associations in existence prior to January 1, 2006 will continue to be governed by the Texas Uniform Unincorporated Nonprofit Association Act until January 1, 2010 unless they have opted into the Business Organizations Code. Unincorporated associations formed after January 1, 2006 or later are governed by the provisions of the Business Organizations Code.

Because scant law exists in Texas related to associations, the remainder of this paper will focus on charitable trusts and nonprofit corporations. Again, as previously alluded to, decision makers of associations should take care to understand fiduciary duties applicable to trustees and corporate directors and govern their conduct accordingly.

B. Fiduciary Duties

1. Generally

Despite the difference in choice of form, all decision makers owe certain fiduciary duties to the organizations they serve. A fiduciary duty is simply a duty to act for someone else’s benefit, while subordinating one’s personal interests to that of the other person. See BLACK’S LAW DICTIONARY 625 (6th ed. 1990). Fiduciary duties are grounded in equity and influenced by the fact-specific and context-intensive flexibility of the law of equity. As such, different rules apply depending on the context, i.e. the relationship between the fiduciary and the beneficiary. Generally speaking, all fiduciaries owe duties of care, loyalty and obedience. While both trustees and corporate directors owe fiduciary duties as a matter of law, because directors are not trustees, the duties owed by directors differ from those owed by trustees. See, e.g., Tex. Rev. Civ. Stat. art. 1396-2.28E; BOC § 22.223.

Trustees owe fiduciary duties to the beneficiaries of the trust. In the context of a charitable trust the duty is owed to named charitable beneficiaries, if any, and more broadly to the public in charity. Accordingly, both the named beneficiaries as well as the state attorney general have standing with respect to claims for breach of fiduciary duty.

Corporate directors owe fiduciary duties to the corporation they serve and to the public in charity. Where the nonprofit corporation has members, the duty is also owed to the members. Therefore, the corporation, its members (if applicable) and the state attorney general have standing for claims of fiduciary breach.

2. Duty of Care

Nonprofit managers are subject to the fiduciary duty of care. The duty of care, at its most basic, is a duty to act in good faith with reasoned competence.

a) Trustees

To satisfy the duty of care, trustees are called upon to exercise the care and skill that a person of ordinary prudence would exercise in dealing with the person’s own property. See SCOTT, LAW OF TRUSTS § 174. As such, a trustee is liable for simple negligence in the performance of his duties. The duty of care begins with the trustee assuming the duties of trustee. See TEX. TRUST CODE § 117.006 (providing that within a reasonable time after accepting a trusteeship or receiving trust assets, the trustee must review the trust assets and make and implement decisions related to the retention and disposition of assets to ensure the trust is in compliance with the terms of the trust and the Chapter 117 of the Texas Trust Code, where applicable). Once the trustee assumes such role, the trustee is under a duty to administer the trust in good faith according to its terms, the Trust Code, and where not inconsistent, the duties imposed on trustees at common law. See TEX. TRUST CODE § 113.051.

Trustees have a duty to make the assets of the trust productive while properly managing, supervising and safeguarding trust funds. See InterFirst Bank Dallas v. Risser, 739 S.W.2d 882, 900 (Tex. App.—Texarkana 1987, no writ). In trusts to which the Uniform Prudent Investor Act (§ 117.001 et seq.) applies, the performance of the entire portfolio should be considered rather than focusing only on individual investments when determining the productivity of the assets of the trust. See TEX. TRUST CODE § 117.004. A trustee may delegate investment decisions if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent’s scope, and periodically reviewing the agent’s actions to confirm conformance with the
terms of the delegation unless the agent is an affiliate of the trustee, arbitration is required by the delegation or the statute of limitations for potential claims is shortened by the delegation. See TEX. TRUST CODE § 117.011.

b) Directors

(1) Generally

With respect to corporate directors, the duty of care mandates that decision makers act in good faith, with ordinary care, and in a manner the director reasonably believes to be in the best interest of the corporation. See Tex. Rev. Civ. Stat. art. 1396-2.28(a); BOC § 22.221(a).

Texas law does not define “good faith” in the context of fiduciaries. Broadly, the term describes “that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one’s duty or obligation.” BLACK’S LAW DICTIONARY 693 (6th ed. 1990). In claims for legal malpractice, for example, “good faith” is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances. See Cosgrove v. Grimes, 774 S.W.2d 662, 665 (Tex. 1989). Thus, at least in the context of legal malpractice, for example, “good faith” is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances. See Cosgrove v. Grimes, 774 S.W.2d 662, 665 (Tex. 1989). Thus, at least in the context of legal malpractice, for example, “good faith” is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances. See Cosgrove v. Grimes, 774 S.W.2d 662, 665 (Tex. 1989). Thus, at least in the context of legal malpractice, for example, “good faith” is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances. See Cosgrove v. Grimes, 774 S.W.2d 662, 665 (Tex. 1989).

“Ordinary care” requires the director to exercise the degree of care that a person of ordinary prudence would exercise in the same or similar circumstances. It should be noted that where the director has a special expertise (e.g., accounting expertise, legal expertise, etc.), ordinary care means that degree of care that a person with such expertise would exercise in the same or similar circumstances. A director may delegate investment decisions if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent’s scope, and periodically reviewing the agent’s actions to confirm conformance with the terms of the delegation. See Tex. Rev. Civ. Stat. art. 1396-2.29; BOC § 22.224.

To satisfy her duty to use ordinary care, the director should be reasonably informed with respect to the decisions she is required to make. Specifically, the decision maker must understand the purposes of the organization as set forth in the organization’s governing documents and make decisions comporting with those purposes and direction. Furthermore, the decision maker should be familiar with management of the organization, policies of the organization, and any financial data relevant to the decisions she is making. Such familiarity and knowledge requires that the director attend board meetings and actively seek the information necessary to make an informed decision regarding which course of action is in the corporation’s best interest. Decision makers of nonprofit corporations that engage in ongoing operations should understand that their duty of care goes beyond financial or business decisions to reach all decisions made in the course and scope of their duties as directors. Finally, while a director may rely on the counsel of advisers, the director must nevertheless exercise her own independent judgment in making decisions as to what is in the corporation’s best interests.

In discharging the duty of care, a director may rely in good faith on information, opinions, reports, or statements, including a financial statements or other financial data, concerning the corporation or another person that was prepared or presented by officers, employees, a committee of the board of which the director is not a member, or in the case of religious corporations, (1) a religious authority; or (2) a minister, priest, rabbi, or other person whose position or duties in the corporation the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented. See Tex. Rev. Civ. Stat. art. 2.28(B). The Business Organizations Code has split this provision into two separate sections with one section being only applicable in the case of religious corporations (BOC § 22.222) and one section being generally applicable to all filing entities (BOC § 3.102).

Decision makers must make decisions they reasonably believe to be in the best interest of the organization. See Tex. Rev. Civ. Stat. art. 1396-2.28; BOC § 22.221. Reasonableness is based on the objective facts available to the decision maker.
(2) Business Judgment Rule

Texas law provides that decision makers of nonprofit corporations are not insurers and thus are not liable so long as those persons exercise their business judgment in making decisions on behalf of the organization. See, e.g., *Campbell v. Walker*, 2000 WL 19143 at * 10,11 (Tex. App.—Houston [14th Dist.] 2000, no writ) (citing *Cates v. Sparkman*, 11 S.W. 846, 849 (Tex. 1889)). The parameters of the business judgment rule in Texas are not well-defined. In addressing issues of a director’s standard of care, negligent mismanagement of a business enterprise and the exercise of business judgment, case law merely provides that Texas courts will not impose liability upon a noninterested director absent a challenged action being ultra vires or tainted by fraud. *See Gearhart Industries, Inc. v. Smith Int’l, Inc.*, 741 F.2d 707, 721 (5th Cir. 1984) (discussing and applying Texas law). However, though not clearly tracking the common law business judgment rule, the Texas Non-Profit Corporation Act and the Business Organizations Code each provide that a decision maker will not be liable for errors or mistakes in judgment if the decision maker acted in good faith with reasonable skill and prudence in a manner the decision maker reasonably believed to be in the best interest of the corporation. *See Tex. Rev. Civ. Stat. art. 1396-2.28(a); BOC § 22.221(a).*

The business judgment rule rests on the concept that to allow a corporation to function effectively, “those having managerial responsibility must have the freedom to make in good faith the many necessary decisions quickly and finally without the impairment of facing liability for an honest error in judgment.” *See MARILYN E. PHELAN & ROBERT J. DESIDERIO, NONPROFIT ORGANIZATIONS LAW AND POLICY 109 (2003) (citing Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973). Because trusts are generally not operating entities in the sense of carrying on their own programs, the concept does not have the same relevance. *See, e.g., Stern v. Lucy Webb Hayes Nat’l School for Deaconesses and Missionsaries, 381 F. Supp. 1003, 1013 (D. D.C. 1974).* While this reasoning may be faulty as trustees may, in fact, carry on their own programs, because the law imposes a higher standard of care on trustees, the business judgment rule does not apply to trustees of charitable trusts. While some have argued that directors of charitable nonprofit corporations should be held to the higher standard of trustees in that a charitable corporation is defined as a charitable trust under Texas law, both the TNPCA as well as the BOC make clear that directors of nonprofit corporations are not trustees. *See, e.g.,* *Tex. Rev. Civ. Stat. art. 1396-2.28E; BOC § 22.223.*

(3) Religious Decisions

Texas courts generally will not interfere with or judge “religious decisions” made by or on behalf of a religious organization. If an organization can establish the particular decision was “religious” or “ecclesiastical” in nature, then courts are reluctant to second guess that decision and prefer not to interfere. This doctrine is referred to the ecclesiastical abstention doctrine. *See Patterson v. Southwestern Baptist Theological Seminary, 858 S.W.2d 602, 603-04 (Tex. App.—Fort Worth 1993, no writ) (discussing the ecclesiastical abstention doctrine).* The ecclesiastical abstention doctrine operates to help eliminate some of the potential claims against decision makers in the religious organization setting. However, decisions that specifically affect civil, contract, or property rights may be subject to court review in Texas under a theory referred to as the “neutral principles of law approach”. *See id.* The neutral principles of law approach holds that where a civil, contract, or property right is affected and the court can make a determination employing only “neutral principles of law” rather than delving into ecclesiastical matters, the court may do so. *See id.*

3. Duty of Loyalty

The second significant fiduciary duty owed by decision makers of nonprofit organizations under Texas law is the duty of loyalty. The duty of loyalty requires that the decision maker act for the benefit of the organization and not for her personal benefit, i.e. the duty of loyalty requires undivided loyalty to the organization.

a) Trustees

The duty of loyalty mandates that a trustee administer the trust property solely for the benefit of the beneficiaries avoiding any transaction that would benefit the trustee to the detriment of the beneficiaries. To ensure compliance with this strict duty of loyalty, the law prohibits conflict of interest transactions even where such transactions are fair to the beneficiaries unless the trustee made full disclosure of the transaction and obtained the consent of the beneficiaries. *See TEX. TRUST CODE §§*
113.060; 117.007. The trustee bears the burden to demonstrate full disclosure and consent. If the trustee is unable to satisfy this burden, the transaction may be set aside regardless of its fairness to the beneficiaries. It should be noted that a loan of trust funds to the trustee or a purchase or sale by the trustee of trust property from or to (i) the trustee or an affiliate; (ii) a director, officer, or employee of the trustee or an affiliate; (iii) a relative of the trustee; or (iv) the trustee’s employer, partner, or other business associate may be set aside irrespective of disclosure. See TEX. TRUST CODE §§ 113.052; 113.053.

b) Directors

As with the duty of care, corporate decision makers are subject to a less exacting application of the duty of loyalty in comparison to a trustee. To satisfy her duty of loyalty, a corporate decision maker must look to the best interest of the organization rather than private gain. As the Texas Supreme Court has stated, the duty of loyalty requires an “extreme measure of candor, unselfishness, and good faith.” See International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 577 (Tex. 1963). The director must not usurp corporate opportunities for personal gain, must avoid improper self-dealing and must make full disclosure of conflicts.

(1) Corporate Opportunity

The corporate opportunity doctrine prohibits a corporate director from usurping corporate opportunities for personal gain. See Holloway, 368 S.W.2d at 577. Where the opportunity is closely related to the operations of the corporation, the fiduciary has an obligation to disclose the opportunity to the corporation. See id. Where such disclosure is not made, the fiduciary has breached her duty and will be held liable unless she can demonstrate that the opportunity was not in the same line of business as the corporation, that the corporation abandoned the opportunity, or that the corporation lacked the financial ability to pursue the opportunity. Importantly, the fiduciary bears the burden to show abandonment or lack of financial ability.

(2) Improper Self-Dealing

Certain transactions between directors and the nonprofit corporations which they serve are strictly prohibited under Texas law. For example, loans to directors are not allowed. See Tex. Rev. Civ. Stat. art. 1396-2.25; BOC § 22.225. Further, directors who vote for or assent to the making of such loans in violation of the statutory prohibition are jointly and severally liable to the corporation for the amount of such loan until the loan is fully repaid. See id.

In addition, though not necessarily self-dealing, directors who vote for or sent to distribution of corporate assets other than in payment of debts, when the corporation is insolvent or when such distribution would render the corporation insolvent, or during liquidation without payment and discharge or making adequate provision for payment and discharge for known debts, obligations and liabilities, are jointly and severally liable to the corporation for the value of the distributed assets to the extent that such debts, obligations and liabilities are not thereafter paid or discharged. See Tex. Rev. Civ. Stat. art. 1396-2.26; BOC § 22.226. Exceptions exist where the director relied in good faith and with ordinary care on information provided by appropriate persons such as officers, professional advisers, committees of the board on which the director does not serve, or the attorney for the corporation. See id.

(3) Conflicts of Interest and Disclosure

Not all interested transactions are improper in the nonprofit corporate context. Where the material facts are disclosed and a majority of the disinterested directors, in good faith and the exercise of ordinary care, authorize the transaction, the transaction is not void or voidable solely because of the director’s interest or the director’s participation in the meeting at which the transaction is voted on. See Tex. Rev. Civ. Stat. art. 1396-2.30; BOC § 22.230. Further, such a transaction will not be void or voidable if it is fair to the corporation when it is authorized, approved or ratified by the board. See id. However, a transaction from which a corporate fiduciary derives personal profit is “subject to the closest examination and the form of the transaction will give way to the substance of what actually has been brought about.” See Holloway, 368 S.W.2d at 577.

Because it is imperative that in the event an issue arises in which a director has a personal interest the director disclose the interest related to the decision being made and abstain from any vote, it is prudent for the organization, and beneficial to the decision makers, for the organization to adopt a conflict of interest policy requiring disclosure of material facts related to actions between the decision maker and the
organization and abstention from voting by the interested decision makers. It is important to note that neither state law nor the Code require a nonprofit corporation exempt as a public charity under § 501(c)(3) to have a conflict of interest policy. With that said, the Service is pushing for the adoption of such policies and includes a question on Form 990 as to whether an organization has adopted such policy. Additionally, the Service has provided a suggested conflict of interest policy for charitable entities. The Panel on the Nonprofit Sector convened by the Independent Sector has suggested that exempt organizations adopt a conflict of interest policy. If an organization chooses to adopt a policy, the policy should consider the following:

1. Identification of the class of individuals covered by the policy;
2. Definition of "actual" and "potential" conflicts of interest;
3. Articulation of the duty of disclosure of officers and directors;
4. Appropriate "trigger" mechanisms to help identify potential conflicts;
5. Annual, episodic disclosure obligations of individuals covered by the policy;
6. Written conflicts disclosure questionnaires;
7. A process for review of disclosed potential conflicts by a committee of disinterested directors with outside counsel’s input;
8. The applicability of the corporate opportunity doctrine to the board;
9. Disclosure obligations regarding outside board service of officers and directors; and
10. Disclosure obligations regarding outside business activities of senior executive leadership.

While breach of the duty of loyalty gives rise to a tort claim under state law, it may also implicate federal tax law as such breach often results in private inurement, a concept which will be discussed more fully below.

4. Duty of Obedience
Along with the duties of care and loyalty, decision makers of nonprofit organizations owe the additional duty of obedience. The duty of obedience requires that the decision maker follow the governing documents of the organization, laws applicable to the organization, and restrictions imposed by donors. The duty of obedience is the subject of another paper to be delivered and therefore will not be discussed in detail here.

C. Standing to Bring a Complaint
While decision makers may be exposed to liability under a number of different theories and thereby exposed to claims from a number of different potential claimants, with respect to the fiduciary duties addressed above, standing to complain of wrongful conduct by the fiduciary is narrow. With respect to charitable trusts, where the trust has named beneficiaries, those beneficiaries have standing to complain of the conduct of the trustees. In addition, because the Office of the Attorney General in Texas (OAG) is the representative of the public interest in charity, the OAG has standing to bring a legal action against a trustee for breach of the trustee’s duties. See TEX. TRUST CODE § 123.001, et. seq. The OAG is charged to ensure charitable assets are used for appropriate charitable purposes and has broad authority to carry out that duty emanating from the Texas Constitution, common law, and various statutes. Where the OAG brings suit alleging breach of one of the fiduciary duties outlined above, venue is in Travis County. See TEX. TRUST CODE § 123.005(a). In the event the OAG is successful in its claims of breach of fiduciary duty, the OAG is entitled to recover from the fiduciary actual costs incurred in bringing the suit and may recover reasonable attorney’s fees. See TEX. TRUST CODE § 123.005(b).

With respect to nonprofit corporations, the organization (and/or its members to the extent the organization has members) may bring an action against a decision maker based on an alleged breach of the decision maker’s duties. Such derivative suits may be brought by a director, member or the OAG.

While the public is the beneficiary of the work of charitable organizations and funds held by charitable organizations are said to be held in trust for the benefit of the public, a member of the public lacks standing on such basis to bring a claim against a decision maker. Rather, the OAG is the proper party to protect the public’s interest. As with charitable trusts, the OAG’s standing is outlined in Chapter 123 of the Texas Trust Code. In very narrow circumstances, a donor may have standing to enforce the terms of his gift when the organization ignores or violates those terms. See Cornyn v. Fifty-Two Members of the Schoppa Family, 70 S.W.3d 895 (Tex. App.—Amarillo 2001, no petition). Such
standing requires that the donor have a special interest in the donated gift. See id.; see also GEORGE G. BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES § 411 (Rev. 2d ed. 1991).

Common causes of action against fiduciaries include breach of fiduciary duty, fraud, negligence (though the parameters of this cause of action are narrowed by the business judgment rule), and conversion (along with defalcation and embezzlement). Remedies include removal from the fiduciary position, actual damages, disgorgement of benefits, imposition of a constructive trust, and in certain circumstances, exemplary damages. It should be noted that a decision maker is not responsible for actions taken prior to his/her taking office, unless the decision maker subsequently ratifies the previous action before beginning to serve. For trustees the standard is slightly different: improperly permitting the breach to continue, failing to make a reasonable effort to compel the predecessor to deliver the trust property, or failing to make a reasonable effort to redress a predecessor’s breach of trust. See TEX. TRUST CODE § 114.002.

III. FEDERAL STANDARDS OF CONDUCT

A. Generally
State restraints on decision makers in the performance of their duties addressed above are only half of the equation. Where the nonprofit also seeks recognition of exemption from taxation, federal tax law imposes additional constraints on decision makers. These constraints: the prohibition on private inurement, the prohibition against self-dealing in the context of private foundations, and the prohibition against excess benefit transactions in the context of public charities apply independently of the concept of breach of fiduciary duty addressed above. In other words, an act may be both a state law breach of fiduciary duty and a violation of federal tax law.

To be entitled to recognition as exempt from taxation, an organization must be organized and operated exclusively for one or more of the purposes set forth in § 501(c) of the Internal Revenue Code. This paper will focus on organizations described in § 501(c)(3). Within this category of organizations, entities are classified as private foundations or public charities. Different standards of conduct apply depending on this latter categorization. Classification as a private foundation or public charity is distinct from choice of form discussed above. However, trusts are generally used in the private foundation context rather than the public charity context.

B. Private Inurement
The private inurement doctrine applies to both private foundations and public charities. Implicit in the requirement that the organization be operated for an exempt purpose is the requirement that it not be operated for private benefit. Within the larger concept of the prohibition on private benefit is the private inurement doctrine, of particular import to the subject of federal standards of care for decision makers.

Included in the definition of an organization exempt under § 501(c)(3) is the requirement that no part of the net earnings of the organization inure to the benefit of any private shareholder or individual. This language constitutes an absolute prohibition on allowing the assets of the organization to be used for the benefit of a person having a personal and private interest in the affairs of the organization along with the ability to control the affairs of the organization. Private inurement can result in the revocation of tax-exempt status. Significant to decision makers of public charities, private inurement can also result in intermediate sanctions being assessed against the decision makers.

C. Private Foundations: Self-Dealing and Other Prohibited Transactions
Private foundations are organizations qualifying for exempt status under § 501(c)(3) other than traditional public charities, publicly supported public charities, supporting organizations, and public safety testing organizations. Sections 4940-4945 of the Code provide for excise taxes related to certain prohibited transactions. Included among the excise tax scheme are taxes against decision makers referred to as foundation managers. Foundation managers are subject to imposition of excise taxes related to acts of self-dealing (§ 4941), jeopardizing investments (§ 4944), and taxable expenditures (§ 4945).

Because of the retention of control involved with private foundations, there are restrictions upon acts of self-dealing under I.R.C. § 4941(d) by certain Disqualified Persons of the foundation.

I.R.C. §4946 defines the term “Disqualified Person.” A Disqualified Person, with respect to a private foundation, is:
1) A substantial contributor to the foundation. Substantial contributor is defined in I.R.C. §507(d)(2) as any person who contributes an aggregate amount in excess of $5,000 to the foundation, if his or her total contributions are more than 2% of the total contributions received by the foundation (since its inception) before the close of the taxable year of the contribution. Substantial contributor also includes:

a) A family member of a substantial contributor (spouse, descendants and spouses of descendants), or any other person who would be a Disqualified Person by reason of his relationship to such person.

b) Persons owning more than 20% of an entity which is a substantial contributor to the foundation. I.R.C. §4946(a)(1)(C),

c) Where the substantial contributor is a corporation, the term also includes any officer or director of such corporation.

2) A foundation manager,

3) A member of the family of anyone described in (1) and (2) above, and

4) A corporation in which persons described in (1),(2), and (3) above own more than 35% of the total combined voting power (more than 35% of profit interest of a partnership or more than 35% of beneficial interest of a trust)

Self-dealing includes any direct or indirect: a) sale or exchange or leasing of property between the private foundation and a Disqualified Person; b) lending of money or extension of credit between a private foundation and a Disqualified Person; c) furnishing of goods, services, or facilities between a private foundation and a Disqualified Person, unless such goods, services or facilities are made available to the general public on at least as favorable a basis as they are made to the Disqualified Person, Treas. Reg. § 53.4941(d)(3)(b)(1); d) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a Disqualified Person, unless compensation is payment for personal services, is reasonable, necessary and not excessive Treas. Reg. § 53.4941(d)(3)(c)(1); e) transfer to, or use by or for the benefit of, a Disqualified Person of the income or assets of a private foundation; and, f) agreement by a private foundation to make any payment of money or other property to a government official [as defined in I.R.C. § 4946(c)] other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period. I.R.C. § 4941(d).

Reimbursement for Expenses: Reimbursement to a director (Disqualified Person) for travel expenses causes the foundation and the director (i.e. a foundation manager) to be potentially liable for penalty taxes for self-dealing, for making noncharitable expenditures, or possibly both. (Additionally, a foundation can lose its exempt status if any of its net earnings inure to the benefit of a private person.) Such reimbursement of expenses will not be taxed if the expenses are reasonable and necessary to carrying out the exempt purposes of the foundation and are not excessive. I.R.C. § 4941(d)(2). The Code does not explain what is “reasonable and necessary.” Treas. Reg. § 53.3941(d)-3(c)(1). Generally, business expense deductions under Treas. Reg. § 1.162-2(1) include travel fares, meals and lodging and expenses incident to travel. Travel expenses are not included if the trip is primarily personal in nature. Treas. Reg. 1.162-2(a). The Code does cross-reference Treas. Reg. § 1.162-7 to determine what is “excessive.” Under Treas. Reg. § 1.162-7, an amount spent on director’s services will not be deemed “excessive” if it is only such as would be paid “for like services by like enterprises under like circumstances.” Treas. Reg. 1.162-7 (i.e. as the organization would pay to someone independent of the foundation). Additionally, a director cannot receive a cash advance for expenses in excess of $500 unless extraordinary expenses are included. Treas. Reg. 53.4941(d)-3(c)(1). Upon receipt of such a cash advance, the director must then account to the foundation under a periodic reimbursement program for actual expenses incurred. If this is done, then the cash advance, additional replenishment of the advance upon receipt of supporting vouchers, or the temporary addition to the advance to cover extraordinary expenses anticipated to be incurred in fulfillment of the assignment will be not considered to violate any act of self-dealing. Only a director or employee is entitled to a cash advance. Treas. Reg. 53.4941(d)-3(c).

Any Disqualified Person who engages in an act of self-dealing is assessed an excise tax of 5% of the
The foundation is subject to a 10% tax on each taxable expenditure, and any foundation manager who willingly participates in making the distribution knowing it is a taxable expenditure, without reasonable cause, is subject to a 2.5% tax on such taxable expenditure. If the expenditure is not corrected within the taxable period, the foundation is subject to a tax of 100% of the amount of the taxable expenditure and the foundation manager is subject to a tax of 50% of the amount of the taxable expenditure, if the foundation manager refused to correct the transaction. The taxable period is the date starting when the expenditure is made and ending the earlier of the date (i) of mailing of a notice of deficiency; or (ii) the tax is assessed.)
D. Public Charities: Excess Benefit Transactions

Public charities are not subject to the excise taxes imposed on private foundations under I.R.C. §§ 4940-4945 discussed above. Rather, a public charity is subject to the intermediate sanctions rules under I.R.C. §4958 and the related Treasury Regulations (Treas. Reg. §§53.4958-1 through 53.4958-8). The final regulations pertaining to I.R.C. §4958, issued in January 2002, apply to excess benefit transactions between an applicable tax-exempt organization (public charity) and a Disqualified Person.

An excess benefit transaction means 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 Person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received by the organization for providing the benefit.

An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a Disqualified Person, or in an exchange of property between a Disqualified Person and the exempt organization. For purposes of determining the value of economic benefits, the value of property, including the right to use property, is its fair market value.

Any disqualified person who benefits from an excess benefit transaction with an applicable tax-exempt organization is liable for a tax of 25% of the excess benefit. The Disqualified Person is also liable for a tax of 200% of the excess benefit if the excess benefit is not corrected by a certain date. Additionally, organization managers (officer, director, or trustee) who knowingly participate in the excess benefit transaction (unless such participation was not willful and was due to reasonable cause) are assessed a tax of 10% of the excess benefit transaction.

A disqualified person is defined as any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction, a member of the family of that person, or an entity that is 35% controlled by a disqualified person. I.R.C. §4958(f).

Note the difference between a disqualified person for private foundation purposes (I.R.C. §4946) and for intermediate sanctions purposes. It is critical to know the definition of a disqualified person under the intermediate sanction rules because if there is no disqualified person, there is no excess benefit transaction.

The following persons are considered to have substantial influence:

a. Presidents, chief executive officers, or chief operating officers,
b. Treasurers and chief financial officers,
c. Voting members of the governing body
d. Persons with a material financial interest in a provider-sponsored organization (generally, in the context of non-profit hospitals)

As such, corporate directors of public charities as well as trustees of charitable trusts that qualify as public charities are deemed to be persons of substantial influence and thus are disqualified persons.

The following persons are deemed NOT to have substantial influence:

a. Tax-exempt organizations described in I.R.C. §501(c)(3),
b. Certain I.R.C. §501(c)(4) organizations,
c. Employees receiving economic benefits of less than a specified amount in a taxable year

Facts and circumstances govern in all other instances. Facts and circumstances tending to show substantial influence:

a. The person founded the organization,
b. The person is a substantial contributor to the organization (within the meaning of I.R.C. §507(d)(2)(A)),
c. The person’s compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls,
d. The person has or shares authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget, or compensation for employees,
e. The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole,
f. The person owns a controlling interest (in vote or in value) in a corporation, partnership, or trust that is a Disqualified Person,
g. The person is a non-stock organization controlled directly or indirectly by one or more Disqualified Persons.

Facts and circumstances showing no substantial influence:

a. The person is an independent contractor whose sole relationship to the organization is providing professional advice,
b. The person has taken a vow of poverty on behalf of a religious organization,
c. Any preferential treatment the person receives based on the size of the person’s donation is also offered to others making comparable widely solicited donations,
d. The direct supervisor of the person is not a Disqualified Person,
e. The person does not participate in any management decisions affecting the organization as a whole or a discrete segment of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole. Treas. Reg. §53.4958-3

All items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services are taken into account in determining the value of compensation. There is a rebuttable presumption of reasonableness, and the payments under a compensation arrangement are presumed to be reasonable and the transfer of property (or right to use property) is presumed to be at fair market value, if the tax-exempt organization follows the following procedures:

a. The transaction is approved by an authorized body of the organization (or an entity it controls) which is composed of individuals who do not have a conflict of interest concerning the transaction,
b. Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability. If the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services,
c. The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:
   a) The terms of the transaction that was approved and the date it was approved,
   b) The members of the authorized body who were present during the debate on the transaction that was approved and who voted on it,
   c) The comparability data obtained and relied upon by the authorized body and how the data was obtained, and
   d) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

Treas. Reg. §53.4958-6

As stated above, if the payment is not a fixed payment, generally, the rebuttable presumption arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption are satisfied.

A disqualified person who benefits from an excess benefit transaction is subject to a two tier excise tax. The first tier tax is 25% of the excess benefit (i.e. the amount by which the value of the economic benefit provided to the disqualified person exceeds the value of the consideration received from the disqualified person). This tax can be abated if the excess benefit is corrected during the correction period, the excess benefit was due to reasonable cause, and the excess benefit was not due to willful neglect. The burden is on the disqualified person with respect to these requirements. IRC § 4962; see also United States v. Boyle, 469 U.S. 241, 245 (1985)(addressing requirements under statutory penalty scheme for late-filed federal estate tax returns). If the excess benefit is not corrected in a timely manner, the disqualified
person is subject to a second tier tax of 200% of the excess benefit.

An excess benefit transaction is corrected by undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the applicable tax-exempt organization involved in the excess benefit transaction in a financial position not worse than that in which it would be if the disqualified person had been dealing under the highest fiduciary duty. Reg. 53.4958-7(a). Practically correction entails returning the “correction amount” (the sum of the excess benefit and interest thereon computed from the date the excess benefit occurred to the correction date). Where the excess benefit was a transfer of specific property, the disqualified person can return the specific property if the organization agrees. In such a case the disqualified person is treated as having made a payment equal to the lesser of the fair market value of the property when it is returned to the organization or when the excess benefit occurred. Reg. 53.4958-7(b)(4)(i).

The disqualified person may not participate in the organization’s decision to accept the property. Reg. 53.4958-7(b)(4)(iii). Due to the rules related to disqualified persons, family members of the disqualified person are also prohibited from participating in such decision.

As previously referenced, an organization manager (i.e. decision maker) who knowingly participates in an excess benefit transaction will be assessed a tax of 10% of the excess benefit not to exceed $10,000.00 unless such participation was not willful and was due to reasonable cause. The decision maker knowingly participates if she has actual knowledge of sufficient facts to demonstrate, based solely on those facts, that the transaction would constitute an excess benefit, is aware that such a transaction may violate federal tax law, and negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or is in fact aware that it is such a transaction. Reg. 53.4958-1(d)(4)(i). The IRS bears the burden to show the organization manager knowingly participated in the transaction. Reg. 53.4958-1(d)(9). The manager will ordinarily not be treated as having knowingly participated if the manager relies on a reasoned written opinion from a professional on matters within the professional’s expertise after giving the professional full disclosure of the factual situation. Reg. 53.4958-1(d)(4)(iii).

Finally, the manager will ordinarily not be considered to have knowingly participated where the organization manager relied on the fact that the requirements for the rebuttable presumption of reasonableness have been satisfied. Reg. 53.4958-1(d)(4)(iv). Willful means voluntary, conscious and intentional. Reg. 53.4958-1(d)(5). Reasonable cause means the manager exercised responsibility on behalf of the organization with ordinary business care and prudence. Reg. 53.4958-1(d)(6).

The tax on organization managers who knowingly participate in the excess benefit transaction tax is an aggregate tax and all managers who fit the definition of liable based on the discussion above are jointly and severally liable. Reg. 53.4958-1(d)(7), (8). The tax is only imposed if the 25% tax is imposed on the disqualified person. Reg. 53.4958-1(d)(1). If the disqualified person benefiting from the excess benefit transaction is also an organization manager, the individual can be subject to both the two tier tax as well as the manager tax.

IV. PROTECTION FOR DECISION MAKERS

While exposure to liability is inevitable, such exposure can be limited through immunity, indemnification agreements, appropriate insurance coverage, and perhaps most importantly, by the decision maker knowing the restraints on her conduct and acting accordingly.

A. Immunity

Limited immunity is available to decision makers under both state and federal law through the Texas Charitable Liability & Immunity Act and the Volunteer Protection Act. See Tex. Civ. Prac. & Rem. Code § 84.001 et seq.; 42 U.S.C. § 14501 et seq. Each statute purports to provide immunity to volunteers (including decision makers who serve as volunteers) from certain liabilities. However, application of these immunity provisions with respect to the issues discussed in this paper is tenuous at best. Each statute excludes liability arising out of duties the volunteer owes to the organization (e.g. duties of care, loyalty, and obedience). Further, neither statute provides immunity from federal excise taxes. Finally, neither statute applies to acts committed that are intentional, willfully or wantonly negligent, or done with conscious indifference or reckless disregard for the safety of others.
B. Indemnification
Texas law provides for indemnification to directors of nonprofit corporations for costs and liabilities incurred in connection with a lawsuit filed against the decision maker due to her position as a decision maker when the organization agrees to such indemnification by including appropriate provisions in its governing documents. The statutory scheme includes both permissive as well as mandatory indemnification while also outlining when indemnification is prohibited.

The Texas Trust Code, while not providing for “indemnification,” does provide for releases and exculpation of trustees. See, e.g., Tex. Trust Code §§ 114.005 (Release of Liability by Beneficiary); 114.007 (Exculpation of Trustee). As with statutory provisions regarding director indemnification, not all liability can be released. See id.

C. Insurance
A nonprofit corporation may provide liability insurance coverage which protects its decision makers in many instances. Providing coverage allows the organization to attract volunteer decision makers who might not otherwise risk personal liability to serve in such positions. Such insurance is also important to obtaining the benefits of the Charitable Liability & Immunity Act discussed above. Decision makers should confirm whether insurance exists, and, if so, the extent of the coverage and its exclusions.

D. Information
Finally, decision makers can help themselves by being diligent in carrying out their duties and responsibilities. Simply knowing what duties are imposed and the law related to the discharge of such duties is an important step in protecting oneself against liability. Following through in the discharge of such duties is perhaps a decision maker’s strongest method of limiting her potential liability.