



Liability Exposures of Nonprofit Directors and Officers

Directors and officers of nonprofit organizations owe a number of duties, including the duties of due care, loyalty, and obedience. These duties are owed to the (1) nonprofit organization, (2) members of the nonprofit organization, (3) employees of the organization, and (3) the general public. Directors and officers also face potential civil and criminal liability for certain acts or omissions.

Duties Owed to the Organization

In many instances in the past, and still today, for-profit corporation law has guided the operational aspects of nonprofits such as formation, voting, and meeting requirements, while issues involving the duties of loyalty and care owed by directors and officers were decided using trust principles. The use of trust principles in interpreting the level of care and loyalty owed by directors and officers of all nonprofits leads to a heightened standard of care and loyalty owed by directors and officers—even where the nature of the nonprofits' operations are nearly identical to for-profit corporations.

Duty of Care

In most states, the directors and officers of nonprofits are now subject to the same standards of care as directors and officers of for-profits; which is the duty of each to exercise his or her judgment as a reasonably prudent person in similar circumstances. Examples of the types of suits resulting from a breach of the duty of due care appear in Exhibit XI.O.3.

EXHIBIT XI.O.3

REPRESENTATIVE CLAIMS RESULTING FROM A BREACH OF THE DUTY OF DUE CARE

- The trustees of a charitable organization sold an old building that had previously housed the poor and used the proceeds to buy a newer, better building. The trustees were sued for wasting the assets of the trust.
- A church secretary sued the members of the church's governing board, alleging that the minister had sexually imposed on her and that the trustees were negligent in selecting the minister and in failing to supervise his activities.
- A plaintiff alleged that the trustees of a private foundation improperly refused to give scholarships to his children. The court held that the complaint was valid and also revoked the foundation's tax-exempt status.
- Directors allegedly authorized an organization to become involved in attempts to influence legislation that was beneficial to the organization. However, such activities jeopardized the organization's tax-exempt status. Members sued the directors and officers as a result of such actions.
- Directors of a charitable organization failed to make dividend distributions to beneficiaries but instead placed the monies in a non-interest-bearing checking account for 5 years. The directors were required to pay the interest that should have been collected and distributed.
- A college and its vice president of operations were sued by a student for damages suffered when she was raped on campus. The defendants were held negligent in failing to provide security, and judgments against both defendants were sustained.
- Museum trustees were sued for improperly storing the museum's art collection, failing to conduct annual audits, releasing a trustee from a long-term lease obligation to the museum without adequate consideration, failing to properly supervise the museum director, permitting private borrowing from the collection, failing to prevent the purchase of nonauthentic art objects, and permitting the facilities to fall into disrepair.

Duty of Loyalty

The duty of loyalty owed by directors and officers of nonprofit corporations includes the duty to avoid conflicts of interest, to avoid interference with corporate opportunity, and to keep the confidence of the corporation.

Appearance of a Conflict of Interest. The breach of the duty of loyalty can arise when a mere appearance of a conflict of interest exists. Examples of alleged breaches of the duty of loyalty include disclosure to third persons of information the director or officer has gained as a consequence of his or her position, commingling funds, purchase by a corporate trustee of its own or an affiliated company's stock, and loans of organization funds to a director or officer. Exhibit XI.O.4 provides additional examples of suits resulting from a breach of the duty of loyalty.

EXHIBIT XI.O.4

REPRESENTATIVE CLAIMS RESULTING FROM A BREACH OF THE DUTY OF LOYALTY

- A trustee pledged assets of a charitable trust to obtain a personal loan. Under California law, trustees are strictly prohibited from self-dealing, and the trustee was held liable.
 - A nonprofit organization was used as a business conduit through which the chairman of the board of the organization personally profited. A creditor of the organization was permitted to recover from the chairman.
 - A charitable hospital corporation owned a parcel of land adjacent to the hospital. The hospital then sold the land to a corporation owned by one of the hospital's trustees. The trustee then used the land to build an apartment and office building. The court held that these facts constituted a conflict of interest and were sufficient to void the sale.
 - A former president of a nonprofit association attempted to purchase land on which the organization's clubhouse was located, for the purpose of building condominiums on the land. Members of the association successfully sued to block the sale.
 - The trustee of a hospital corporation, who was also the corporation's attorney, was paid a finder's fee in connection with a hospital transaction. A lawsuit was successful in preventing the attorney from receiving the finder's fee.
-

Duty of Obedience

Directors and officers are required to perform their duties in accordance with applicable statutes and within the terms of the organization's charter. In addition to observing the formalities and separate existence of the organization, directors and officers must also obey a variety of laws that may impose direct liability on them for wrongful conduct. Examples of suits from statutorily imposed liability on nonprofit directors and officers are shown in Exhibit XI.O.5.

EXHIBIT XI.O.5

EXAMPLES OF STATUTORILY IMPOSED LIABILITY

- Employment practices liability suits
 - Antitrust suits
 - Copyright/Patent suits
 - Employee Retirement Income Security Act (ERISA) suits
 - Pollution suits
 - Physician credentialing suits
 - Securities law suits
 - Suits under miscellaneous state statutes
-

Duties to Members

As already discussed, nonprofit corporations do not have a class of persons who have an equity interest in the corporation. While some nonprofit corporations may have members with voting privileges affecting the operation of the corporation, many nonprofit corporations do not even have members. Thus, nonprofit corporations generally do not have a class of persons with a sufficiently significant financial interest in the operation of the corporation to bring a derivative or class action suit.

However, where a nonprofit corporation *has* members, the directors and officers do have duties to the members and may be liable for breaches of those duties. The duties of a director or officer to the membership of a nonprofit corporation are, for the most part, encompassed within the general duty of loyalty and due care owed to the

corporation itself.

Duties to Employees

The hiring, promotion, and termination of employees make up one of several areas of potentially significant exposure for directors and officers of for-profit corporations. For directors and officers of nonprofit corporations, employee-related claims are the single most serious area of exposure and, depending on the type of nonprofit, constitute roughly 80 percent of all claims made against the directors and officers of NPOs.

Employee lawsuits are frequently brought but generally do not result in substantial financial judgments or settlements. In the context of nonprofits, however, the frequency of such claims presents a substantial aggregate exposure, and the cost of defending these claims may threaten the existence of the often thinly capitalized nonprofit corporation.

Exemptions from Liability to Employees

It should be noted, however, that nonprofits with fewer than 15 employees and certain types of NPOs that are considered "private membership clubs" may be exempt from a number of federal employment statutes. For instance, the Americans with Disabilities Act of 1990, like Title VII, does not apply to employers with fewer than 15 employees or to private clubs. The Age Discrimination in Employment Act applies only to employers with 20 or more employees.

Duties to the General Public

Besides owing a duty of care and loyalty to the nonprofit corporation itself and duties to its members and to its employees, directors and officers of all corporations also owe duties to the general public. Thus, NPOs, like all for-profit entities, must abide by the criminal and civil laws of the federal and state government.

IRMI publication date for this page: July 2011

© 2000-2011 International Risk Management Institute, Inc. (IRMI). All rights reserved.