

RESPONSIBLE MANAGEMENT:

*Duties and Liabilities of Directors, Officers and Trustees of Nonprofit
Arts Organizations*

A PUBLICATION OF TEXAS ACCOUNTANTS AND LAWYERS FOR THE ARTS

A WORD ABOUT TEXAS ACCOUNTANTS AND LAWYERS FOR THE ARTS

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CHAPTER ONE

INTRODUCTION

Nonprofit arts organizations are largely the product of the skill, vision and commitment of their directors. These directors often work long hours and in a volunteer capacity to nurture an organization's activities and growth. Such people are indispensable to the existence of the nonprofit arts organization and, in fact, to the development of the arts themselves within the private sector.

Recent events have caused directors of nonprofit organizations of all types to question the role being undertaken when a directorship is accepted. A perception of an increasing amount of litigation in the for-profit sector combined with increased governmental scrutiny of nonprofits has emphasized the fact that such a position is not merely an honor but one which carries with it both responsibility and potential liability. Although actual litigation involving nonprofit directors is extremely rare, the concern is real. The acceptance of a nonprofit directorship does carry with it the acceptance of duties that, if breached, could result in liability. It must be simultaneously stressed that these duties are not onerous and that if care is exercised to understand their scope and carry them out, the risk of liability will be minimized.

This booklet is designed to respond to the current climate of concern by realistically and clearly describing the responsibilities and potential liabilities of nonprofit organization directors, particularly the director of the nonprofit corporation. As lawyers, we must, of course, present such issues in the context of their full range of legal possibilities. It would be unfair and unwise, however, to offer this material without also emphasizing three practical concepts already touched upon in this introduction. First, nonprofit arts organizations and the rich cultural opportunities they offer cannot exist without dedicated and skilled directors. Moreover, the real risks of liability as measured by the incidence of actual litigation may be less than the following discussion might suggest. Finally, any such risks can be further diminished if all directors understand the responsibilities inherent in the positions being accepted. The purpose of this booklet is to facilitate such an understanding.

As lawyers, we must also mention that all information in this handbook is current as of the date of publication only. The law, however, and particularly the tax law, is not static and periodic changes are common. Consequently, references to statutory provisions and rules of law should be verified for their continued validity. Nothing in this booklet is to be considered as the rendering of legal advice for specific cases, and readers should always consult with their own legal counsel. Three other TALA publications, *Financial Management of Nonprofit Arts Organizations: A Guide to Fiscal Survival*; *Insurance: A User-Friendly Guide for the Arts and Nonprofit World*; and *Pas de Deux: Labor and Employment Issues in the Arts and Nonprofit World*, address the management and financial issues of tax-exempt organizations once they are formed.

CHAPTER TWO

CHOOSING THE BEST FORM FOR YOU NONPROFIT ORGANIZATION

The term "nonprofit," as used in the booklet to describe an organization, is the equivalent of "not for profit," meaning that no part of the organization's income is distributable to its members, directors, officers or administrators except for reasonable salaries and expenses. Profits are to be used in furtherance of the organization's charitable purpose.

State Law Classification: Nonprofit Corporations and Unincorporated Associations

Nonprofit organizations generally take one of two forms for state law purposes: nonprofit corporations or unincorporated associations. Individuals and partnerships are not eligible for the favorable federal income tax status that may be enjoyed by certain nonprofit organizations.

Corporations are in most cases the preferable form for nonprofit arts organizations. In Texas, nonprofit organizations may be incorporated under the Texas Nonprofit Corporation Act, referred to in this booklet as the "TNPCA". An organization so incorporated is recognized by the law as an entity separate and distinct from its members (if it has any). Accordingly, a nonprofit corporation may contract and hold property in its own name. Other legal attributes generally associated with nonprofit corporations are centralization of management and limited liability for members, although the latter attribute may be lost in certain instances. A nonprofit corporation may be of perpetual duration. In addition, the TNPCA provides a relatively detailed framework for the organization's charter and bylaws to contain provisions expanding on and, in some cases, overriding the statutory provisions. The TNPCA does require, however, that nonprofit corporations soliciting or receiving contributions from sources other than its own membership in excess of \$10,000 per year maintain financial records, prepare detailed annual financial reports and make available for public inspection such records and reports (with certain exceptions not generally relevant to arts organizations).

The second form that nonprofit organizations may take is that of the unincorporated association. An unincorporated association is a group of persons organized for a particular purpose and operating without a charter from the state. Generally, such organizations function in a manner similar to corporations; however, because the organization has no charter, it is not recognized by the law as a separate legal entity and is therefore incapable of holding title to property, contracting or suing or being sued in its own name. Persons contracting on behalf of an unincorporated association may be held personally liable for the association's contracts, and one member may be held liable for the acts of another under principles of partnership and agency law. Statutory provisions dealing with unincorporated associations are scarce. In general, operating in a corporate form has many advantages over operating as an unincorporated association. For this reason, none of the discussion that follows will specifically address issues peculiar to unincorporated associations.

Federal Income Tax Classification: Public Charities and Private Foundations

Section 501(a) of the Internal Revenue Code of 1954, referred to in this booklet as the Code (all section references in this subchapter are to sections of the Code), provides that organizations described in section 501(c) are exempt from federal income tax. This general rule, however, is subject to a number of exceptions, notably the unrelated business income tax provisions of sections 511 through 514.* For the purpose of this discussion, it is assumed that the typical nonprofit arts organization will seek an exemption from federal income tax as a result of being an organization described in section 501(c)(3), that is, an organization which is 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, or for the prevention of cruelty to children or animals. More specifically, arts organizations normally fall under the "charitable" and/or "educational" categories. Section 501(c)(3) further provides that an organization described in such sub-section: (1) may not have any part of its net earnings inure to the benefit of any private shareholder or any individual, (2) may not devote a substantial part of its activities to carrying on propaganda, or otherwise attempting, to influence legislation, and (3) may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Since the Tax Reform Act of 1969, an organization seeking a determination from the Internal Revenue Service ("IRS") that the organization meets the criteria of section 501(c)(3) is faced with the additional hurdle of establishing to the satisfaction of the IRS the organization's status as a "public charity" if the organization does not want to be treated as a "private foundation." Those section 501(c)(3) organizations treated as other than private foundations pursuant to section 509(a) are generally referred to as public charities. Generally, any organization described in section 501(c)(3) other than a public charity will be treated as a private foundation. The classification of a Section 501(c)(3) organization as a private foundation or a public charity can play a pivotal role in the organization's operations and fund-raising. It is usually preferable for a nonprofit arts organization to be a public charity. Thus, a general discussion of the requirements of becoming a public charity is in order. Generally, there are three categories of public charities. The first category is sometimes referred to as the "common-law public charities" and includes those organizations that have been viewed by the public and the common law as being responsive to public needs. This category includes organizations such as churches, schools, hospitals, and medical research organizations.

The second category of public charities, and that particularly applicable to arts organizations, are referred to as "publicly-supported organizations." There are two types of publicly-supported organizations, one being defined in section 509(a)(2) and the other referred to in section 509(a)(1) and defined in section 170(b)(1)(A)(vi) and the Treasury Regulations promulgated thereunder. It should be emphasized that in order to qualify as a public charity as a result of being a publicly supported organization, the organization must continue to meet either of the publicly supported tests. It is not enough to satisfy either of the tests at any given point in time,

* For a complete discussion of the practical effect of these provisions on section 501(c)(3) organizations, see pages 35-46 of TALA's booklet "Financial Management of Nonprofit Arts Organizations: A practical Guide for Fiscal Survival."

but rather the test must be satisfied on a moving four-year basis, that is, the period used in determining satisfaction of the test for a particular tax year is the four-year period preceding such year.

The section 509(a)(2) definition of a publicly supported organization is commonly referred to as the "1/3-1/3" test. Generally stated, this test requires that the organization must receive more than one-third of its support from permitted sources (generally sources other than officers and members of the organization's governing body, substantial contributors, and individuals and entities related to such foundation directors and contributors), and that the organization must not receive more than one-third of its total support from gross investment income. An example of a permitted source, subject to certain statutory limitations, would be income from an exempt activity such as a theatrical performance by a theatre group. As can be seen, this definition precludes an organization from relying on a small number of substantial contributors for support or from having a successful fund-raising drive in a given period and attempting to retain its public charity status during those subsequent years that it is deriving its support from income generated by the resulting endowment.

The other definition of a publicly-supported organization is referred to in section 509(a)(1) and is contained in the Treasury Regulations promulgated under section 170(b)(1)(A)(vi). Generally stated, this test requires that the organization must receive more than 33-1/3% of its total support from contributions from members of the general public. In certain limited instances, the 33-1/3% requirement is reduced to 10% under a subjective "facts and circumstances" test. In determining whether the 10% or 33-1/3% tests are satisfied, contributions from anyone person can only be included in the numerator to the extent that such amount does not exceed 2% of the total support derived by the organization.*

The third category of public charities is provided for in section 509(a)(3), and organizations described therein are generally referred to as "supporting organizations." A supporting organization is an organization that is organized and operated solely for the benefit of one or more common-law public charities or publicly supported organizations. An example would be an entity formed solely to raise revenues for a specific dance company. A supporting organization cannot be operated for the benefit of another supporting organization. In addition to the designation of the supported organization in the governing instruments of the supporting organization, the relationship between the supported and the supporting organizations must be one of three types. The easiest relationship to establish is a relationship that is comparable to that of a parent and subsidiary corporate relationship. The other two relationships are not quite as easy to establish and require sophisticated planning.

As mentioned above, an organization's private foundation/public charity status is important both from a fund-raising and an operational viewpoint. As used in this paragraph, the term "private foundation" does not include either a private operating foundation or a private foundation referred to in section 170(b)(1)(E)(ii) and commonly called a "pass through" private foundation. From a fund-raising viewpoint, a private foundation does not enjoy the same preferable position

* For a more detailed discussion of these two public support tests, see pages 27-31 of "Financial Management of Nonprofit Arts Organizations."

as a public charity with respect to contributions from an individual; as a general rule, contributions to a public charity can be deducted in an amount up to 50% of the donor's contribution base as opposed to 30% (20% in the case of contributions of capital gain property) of the donor's contribution base for contributions to a private foundation. In addition, from a fund-raising perspective, it is important to note that a private foundation will typically encounter problems in seeking to raise support from other private foundations. This result arises from the fact that a donor private foundation may not count grants to another private foundation in determining whether the donor private foundation has satisfied its mandatory distribution requirements (section 4942, discussed below) and the fact that the donor private foundation must exercise what is referred to as expenditure responsibility with respect to a grant to another private foundation (section 4945, discussed below). These two factors combine to discourage private foundations from making grants to other private foundations.

Private foundations are subject to a variety of detailed statutory provisions and regulations respecting their operations. The majority of these provisions are found in Chapter 42, the principal sections of which are summarized in the discussion that follows. The taxes imposed by the Chapter 42 provisions are on the private foundation (except in the case of the self-dealing provisions of section 4941) and, in some instances, the private foundation's directors.

Section 4940 imposes a 2% excise tax on the net investment income of a private foundation. The section 4940 tax is reduced to 1% if the private foundation meets certain requirements relating to the private foundation's making of qualifying distributions in excess of those required by section 4942 (see discussion below).

Section 4941 sets forth detailed rules governing dealings or transactions between a private foundation and its "disqualified persons" (generally officers and members of the private foundation's governing body, substantial contributors to the private foundation, and individuals and entities related to such foundation directors and contributors). As a general rule, a private foundation cannot enter into transactions with any of its disqualified persons. The most notable exception to this general rule is that a private foundation may pay compensation to a disqualified person for personal services if the services are reasonable and necessary to the carrying out of the private foundation's exempt purposes and the amount of such compensation is not excessive. This rule does not apply to public charities, although as described below, such transactions are subject to certain limitations.

Section 4942 requires a private foundation to make "qualifying distributions" each year in an amount which is in excess of 5% of the fair market value of the private foundation's assets which are not used directly in carrying out the private foundation's exempt purposes (that is, generally 5% of the private foundation's investment portfolio). "Qualifying distributions" include (a) grants to public charities and private operating foundations (see section 4942)(3)) which are not controlled by the private foundation and (b) payment of reasonable administrative expenses.

Section 4943 sets forth provisions that restrict the ability of a private foundation to have certain types of business holdings. As a general rule, a private foundation cannot own more than a 20% interest in a business enterprise such as a corporation or a partnership. This 20% permitted holding percentage is reduced by the percentage held by the private foundation's disqualified

persons in the same business enterprise. It should be noted that section 4943 prohibits a private foundation from having an interest that is or is tantamount to a sole proprietorship. In contrast, public charities may have wholly-owned business subsidiaries, and some find it advantageous to do so.

Section 4944 provides that a private foundation may not make any investments that jeopardize the ability of the private foundation to carry out its exempt purposes both on a long-term and short-term basis. Section 4945 provides that a private foundation may not make grants to other private foundations (including certain private operating foundations) and individuals unless the grantor private foundation complies with the requirements of section 4945. Generally, in the case of grants to individuals, the private foundation must seek advance approval of the grant-making program from the IRS to establish that such grants are objective and nondiscriminatory. Generally, in the case of grants to private foundations (including for this purpose certain private operating foundations), the grantor private foundation must exercise expenditure responsibility with respect to such grants. The exercise of expenditure responsibility generally requires (i) a pre-grant inquiry by the grantor as to the affairs and management of the grantee, (ii) a written agreement between the grantor and grantee setting forth the permitted and prohibited uses of the grant and the requirements relating to reports to the grantor from the grantee and (iii) reporting from the grantee to the grantor and reporting by the grantor to the IRS. This section also further limits the ability of a private foundation to engage in political activities.

As the above discussion indicates, status as a public charity affords a nonprofit organization far more management flexibility and a broader range of permissible activities than does that of a private foundation. For an arts organization engaged in exempt activities and fund-raising efforts it is the designation of choice.

CHAPTER THREE

UNDERSTANDING RESPONSIBLE MANAGEMENT: DUTIES AND LIABILITIES OF DIRECTORS AND OFFICERS

The officers and directors (collectively, the "directors") are the persons charged with the management of nonprofit organizations and owe a duty of care, loyalty and obedience to the organization. Chapter Three examines these duties and the potential liability facing directors for breach to these duties as well as for violation of specific statutory requirements and prohibitions.

The duties applicable to directors of nonprofit entities will vary depending upon the type of entity chosen by the founders. The duties applicable to directors of nonprofit corporations have largely been borrowed from the duties applicable to business corporations. By contrast, the duties applicable to charitable trusts are largely the same duties applied to trusts in general. In addition, special rules often apply for private foundations that borrow from both traditional trust and business corporation law. Since the form of the entity will play a key role in determining the standard of care, the standards applicable to both charitable trusts and nonprofit corporations will be reviewed. Where required, private foundations will be separately addressed.

The Duty of Care

Texas courts have stated that the directors of a business corporation owe a duty of care to the shareholders and that this duty of care requires that such directors act (i) in good faith, (ii) with ordinary care, and (iii) in a manner the director reasonably believes to be in the best interests of the corporation. The legal consequences of these duties is that directors will be liable for their own simple negligence, mistakes of judgment or mistakes of fact. To protect against this result, Texas, like many other jurisdictions, has adopted the business judgment rule to modify the duty of care. The business judgment rule modifies the duty of care by providing that a director acts with ordinary care if the director acts with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. When acting as an ordinarily prudent person, directors will not be held liable for mistakes of business judgment that may damage corporate interests. When used as a defense to a charge of breach of the duty of care, the business judgment rule shields a corporate director from liability for any mistakes of fact or judgment. The director must still act in good faith, without corrupt motive, and where the facts and circumstances surrounding a particular act or transaction are such as to indicate that a total lack of an informed business judgment, the director will not receive the protections of the business judgment rule.

Until 1993, there was some ambiguity as to whether directors of nonprofit corporations should have a duty of care similar to trustees or directors of business corporations. The 1993 amendments to the TNPCA settled that question by stating, "[a] director is not deemed to have the duties of a trustee of a trust with respect to the corporation." The 1993 amendments stated that a nonprofit director is not liable to the corporation, any member or any other party, if the director acted in good faith, with ordinary care, and in a manner that the director reasonably believes to be in the best interests of the corporation. Until recently it was also unclear whether or not some rules applied equally to the officers of the nonprofit corporation. Effective

September 1, 2001, a new Section 2.22 of the TNPCA was enacted which clarified that the same rules apply to officers as well as directors.

Trustees appointed to manage trust property also owe a duty of care to the trust. Unlike corporate directors, a trustee's duty of care has not be limited by the business judgment rule. As a result, trustees are held to a higher standard of care than corporate directors. The trust instrument may, however, adopt limits to the trustee's duty of care similar to the business judgment rule. The business judgment rule does not apply to a decision in which the director has a conflict of interest. The business judgment rule will not, for example, protect a director who receives a personal benefit from the corporation. The duty of loyalty will apply in these situations.

The Duty of Loyalty and Self-Dealing Transactions

In connection with business corporations, a director's duty of loyalty requires that the director act in good faith and not allow personal interest to prevail over the interest of the corporation. A 1985 amendment to the Texas Business Corporation Act provided that no "interested director transaction" is void or voidable solely because the "interested director" is present at or participates in the board or committee meeting at which the transaction is authorized, or solely because the interested director's vote is counted for such purpose, if:

- 1) The transaction is authorized in good faith by a majority of the disinterested directors following disclosure to them of the material facts as to the transaction and the interested director's interest in the transaction,
- 2) The transaction is approved by vote of the shareholders after similar disclosure, or
- 3) The contract is fair to the corporation at the time it is authorized, approved or ratified, with the burden of proof on these issues being borne by the interested director.

In 1993, section 2.30 of the TNPCA adopted this standard for nonprofit corporations. An "interested director transaction" occurs when the nonprofit corporation enters into any contract or transaction with (i) one or more of its directors or officers, or (ii) any corporation, partnership, association or other organization in which one of its directors or officers is also a director or officer or has a financial interest. An "interested director" is a director with a financial or other interest in the contract or transaction. Contracts and transactions with "interested officers" are also subject to the same rules. As was the case with the duty of care, the duty of loyalty imposed on the trustee of a trust is more stringent than the duties imposed upon directors of business corporations. Trust law provides that the trust may void any self-dealing or conflict of interest transactions engaged in by a trustee. In the trust context, the fiduciary duties imposed on the trustee protect the trust beneficiaries from overreaching and mismanagement by the trustee. One reason for this heightened standard is that it is difficult for beneficiaries to learn about and prove trustee misconduct.

Special Treatment of Private Foundations

It should be emphasized that the provisions of the Code dealing with private foundations (including nonprofit corporations or charitable trusts organized as private foundations) impose strict prohibitions on transactions between a private foundation and its disqualified persons. See Chapter Two for a general discussion of section 4941 of the Code.

The following example illustrates the harsh consequences to a disqualified person for violation of the strict self-dealing prohibitions of section 4941. Assume A, who is a director and thus a disqualified person, buys an asset from private foundation Z for \$1,000 and that director A subsequently sells that asset to a third party for \$2,000, making a profit of \$1,000. Assume further that the asset appreciates in value to \$3,000 in the hands of the third party or a subsequent transferee by the time director A takes the action required by section 4941 to "correct" the act of self-dealing. Section 4941 requires director A to correct the act of self-dealing by paying to foundation Z the difference between the amount director A paid foundation Z for the asset (\$1,000) and the greater of the amount director A sold the asset for (\$2,000) or its fair value at the time of correction (\$3,000), thus requiring director A to pay foundation Z twice the amount of the profit. In addition, for each taxable year or portion thereof prior to correction, section 4941 requires director A to pay (i) a tax equal to 5% of the initial amount involved (\$1,000) as a result of the self-dealing, (ii) a tax equal to 2 Y2%of the amount involved as a result of director A's foundation director status, (iii) additional penalties of up to 200% (as a result of the self-dealing), and (iv) 50% (as a result of director A's foundation director status) of the initial amount involved.

The Duty of Obedience and Contract Liability

The duty of obedience requires directors to avoid committing acts beyond the scope of their powers as defined by applicable law, the corporation's governing document and resolutions of the governing body. Violations of the duty of obedience most often arise in the context of unauthorized contracts made by a director.

Directors and Officers

The liability of officers and directors on corporate contracts is governed by well-established principles of agency law. Where a corporate officer makes an authorized contract in the name of the corporation, the contract is with the corporation only, and the other party to the contract cannot hold the officer personally liable. Where the officer makes an unauthorized contract in the name of the corporation that is within the corporation's powers, the officer may be personally liable to the corporation for any damages incurred by the corporation as a result of the contract. The contract is binding on the corporation so long as the other party has no reason to know of the officer's lack of authority.

Consider the following example of a director's liability to the corporation for an unauthorized act. At a regular meeting of the board of directors, director A of nonprofit corporation Z suggested a specific fund-raising activity. Although no vote was taken, the other directors clearly disapproved of the idea. Disgruntled, director A indicates director A's determination to

hold the event regardless of the concurrence of the other directors and advertised the event as being sponsored by nonprofit corporation Z. Unfortunately, the event was poorly planned and lost two thousand dollars. All contracts with vendors had been signed by director A on behalf of and as a director of nonprofit corporation Z. It was in nonprofit corporation Z's power to hold a fund-raising event. In addition, director A had apparent authority to sign for nonprofit corporation Z. Nonprofit corporation Z was, therefore, liable to the third parties involved for the contracts signed by director A. Director A was, in turn, liable to nonprofit corporation Z for repayment of the unauthorized expenditure of funds. In theory, the ability of nonprofit corporation Z to recover the funds from director A provides a satisfactory resolution to the problem from the perspective of nonprofit corporation Z. In fact, it may be impossible or impractical to sue such a board member for the funds spent to satisfy the contract due to the cost of such litigation or the financial situation of the errant director. The moral of the story: Nonprofit organization directors must understand that any power to act comes from the delegation of the board of directors. If there is no delegation there can be no authorized act.

Liability to Third Parties for Tortious Conduct

A tort has been defined as a private or civil wrong or injury, other than breach of contract, for which a court will provide a remedy in the form of an action for damages. A tort arises from a violation of a duty owed by the defendant to the plaintiff. Generally, such a duty must arise by operation of law and not by contract. As a general rule, every person is liable for his or her own torts. Under certain circumstances, however, a director or trustee of a nonprofit entity may be able to be reimbursed or indemnified by the organization for torts committed by the director or trustee in the course of activities conducted on behalf of the organization.

The Texas Trust Code provides that a trustee is personally liable for a tort committed by the trustee or by the trustee's agents or employees in the course of their employment but that this liability may be paid from trust funds (or the trustee may be reimbursed with trust funds for its payment of the liability) if:

- (1) the trustee was properly engaged in a business activity for the trust and the tort is a common incident of that kind of activity;
- (2) the trustee was properly engaged in a business activity for the trust and neither the trustee nor an officer or employee of the trustee was guilty of actionable negligence or intentional misconduct in incurring the liability; or
- (3) the tort increased the value of the trust property (in this latter case, the liability may be satisfied with trust funds only to the extent of the increase in the value of the trust property).

Thus, in the absence of a contrary provision in the trust instrument, a trustee generally will be liable without reimbursement from trust funds for the trustee's negligence or intentional misconduct except where the negligence is a common incident of the trust's business activity being conducted by the trustee. As with trustees, officers and directors of nonprofit corporations are generally personally liable for their torts committed in the management of the nonprofit

corporation's affairs. The officers and directors may, however, be indemnified from such liability by the nonprofit corporation in certain circumstances, as more fully described in Chapter Four.

Specific Statutory Requirements and Prohibitions

In addition to the liabilities discussed earlier in this chapter, there are other potential liabilities facing directors of nonprofit organizations who violate specific statutory prohibitions or fail to abide by specific statutory requirements. The fundamental concept of a nonprofit corporation is that no part of its income shall be distributed to its members, directors or officers. Exceptions to this rule allow the corporation to pay compensation in a reasonable amount to its members, directors or officers for services rendered and to confer benefits upon members in conformity with its purposes. Directors who vote for or assent to a wrongful distribution may be held liable to the corporation for a violation of this statutory prohibition, and the member, director or officer receiving the wrongful distribution may be held liable for its return.

When the corporation is in the process of liquidation or faced with imminent insolvency, the corporation is prohibited from making any distribution of assets other than in payment of its debts. Any director who votes for or assents to any such wrongful distribution of assets is jointly and severally liable to the corporation for the value of the assets distributed, to the extent that the debts, obligations and liabilities of the corporation are not thereafter paid and discharged. A director who is held liable for such a wrongful distribution has a claim against the person receiving such distribution only if such person knew the distribution was made in violation of the statute.

Loans by a nonprofit corporation to its officers or directors are strictly prohibited. Directors voting for or assenting to the making of any such loan, and any officers participating in the making of such loan, are jointly and severally liable to the corporation for the amount of such loan until repayment thereof.

With respect to each of these specific statutory prohibitions, it should be noted that a director present at a meeting at which action is taken in violation of the foregoing prohibitions is presumed to have assented to such action unless the director files a written dissent against such action with the secretary of the meeting before the adjournment of such meeting or forwards such dissent by registered mail to the corporate secretary immediately after the adjournment of the meeting. Recognizing the burden placed on directors of nonprofit corporations by requiring them to ascertain the state of the corporation's solvency prior to any distribution of assets other than to creditors, the statute specifically provides that the director shall not be liable for a wrongful distribution of assets if, in the exercise of ordinary care, the director relied and acted in good faith upon information, opinions, reports, or statements, including financial statements and other financial data concerning the corporation that was prepared by (i) one or more officers or employees of the corporation, (ii) legal counsel, public accountants, others persons as to matters that the director reasonably believes are within the person's professional or expert competence, or (iii) a committee of the board of directors of which the director is not a member. While not required, it is preferable that these reports be in writing. Absent knowledge or reason to know that the assets of the corporation are worth less than their book value, a director is entitled to

consider the assets to be of their book value.

As previously discussed in Chapter Two and the subchapter "The Duty of Loyalty and Self-Dealing Transactions" in this Chapter Three, there are a number of specific statutory provisions respecting the operations of private foundations. A private foundation's "foundation managers" (officers or directors) are subject to tax in the event they knowingly participate in a transaction which results in an act of self dealing under Section 4941, a jeopardy investment under section 4944, or a taxable expenditure under section 4945. There are two levels of such taxes. The initial tax ranges from 2-1/2% (sections 4941 and 4945) of the amount involved to 5% (section 4944). If the act giving rise to the initial tax is not corrected within a specified period, an additional tax is imposed. The additional tax ranges from 25% (section 4944) to 50% (sections 4941 and 4945).

Standing to Sue

The classes of persons accorded standing to sue to redress breaches or violations of the duties or statutory prohibitions described in this Chapter are not as numerous as one might think. Article 4412a of the Texas Revised Civil Statutes, which treats all corporations and trusts described in section 501 (c)(3) of the Code (specifically including arts organizations) as "charitable trusts," generally provides that the Attorney General is a proper party to and shall be given notice of certain suits or judicial proceedings involving such charitable trusts and that the Attorney General may institute proceedings alleging breach of fiduciary duties by "trustees" of such charitable trusts. Whether the Attorney General has the exclusive right to bring such suits depends upon the classification of the corporation or trust as a "public charity" or "private charity." Where a charity is for the benefit of the public at large or a considerable portion of it, and the language of its creation is such that no particular individuals can be pointed out as the objects to be benefited by it (a "public charity") the Attorney General, as the official representative of the public, is the only party given standing to sue to vindicate the public's rights in connection with such a charity. It is, however, important to remember that the Attorney General often decides to act or not act based on complaints filed which may come from donors or members of the public generally.

On the other hand, notwithstanding that a trust may be charitable in character and may look generally to the benefit of the public, if by the terms of the trust instrument it is possible to ascertain definite persons or groups as beneficiaries, they will be deemed to have such a special or active interest to justify standing to sue. Nonprofit arts organizations which benefit the public generally and not any particular group are public charities, and persons having no special interest different from that of the general public have no standing to sue for breach of duty or to enforce the terms of the "charitable trust."

Of course, a nonprofit corporation itself can sue officers or directors to redress breaches of their fiduciary duty. But, as one might expect, frequently the very individuals who would be sued are the ones who would have to take action to bring a suit. Where a nonprofit corporation has members, such members are generally granted standing to sue to protect their interests. This is consistent with the general rule outlined above since members of a nonprofit corporation are an identifiable group, presumably with interests different from those of the public generally.

Donors to a nonprofit organization are generally not granted standing merely as a result of having made a donation. If the donor has some residual or reversionary interest in the property donated, however, the donor may sue to protect such interest.

Third parties are, of course, granted standing to sue a nonprofit corporation or a trust for its breach of contract and, as discussed in Chapter Three, individuals may be sued for their torts. By analogy to business corporations, where members or directors of a nonprofit corporation have disregarded corporate formalities and the corporation is their "alter ego," they may be sued individually for the nonprofit corporation's liabilities.

CHAPTER FOUR

PROTECTING YOUR DIRECTORS: INDEMNIFICATION AND INSURANCE

It is imperative that the most talented and hardworking individuals not be discouraged from accepting positions as directors or officers of nonprofit organizations. In view of the potential liabilities discussed in Chapter Three, it is all too obvious why a person might decline to accept a position with a nonprofit organization. While the person may be otherwise inclined to serve, he might understandably decide that service is simply not worth the exposure of his or her personal assets. However, with indemnification (reimbursement by the organization for liabilities incurred by the director), insurance and risk management, the risk of liability for the conscientious director, trustee or officer can be minimized to an acceptable level.

Nonprofit Corporations - Mandatory Indemnification

Under Article 2.22A of the TNPCA, adopted in 1985, a Texas nonprofit corporation must indemnify an officer or director or a former officer or director against reasonable expenses (court costs and attorneys' fees) incurred by the director in connection with a proceeding in which the director was a named defendant or respondent because the director is or was a director or officer if the director has been wholly successful in the defense of the proceeding. The statute allows the corporation, to adopt a provision in its articles of incorporation which restricts a director's right to this mandatory indemnification. Unless the corporation simply cannot offer its directors any indemnification because of budgetary constraints, it is difficult to imagine why indemnification would be denied in these circumstances. The director who has been wholly successful in a defense seems the most worthy of indemnification. Restriction of the right to mandatory indemnification would almost certainly discourage a candidate's acceptance of positions with nonprofit corporations.

Nonprofit Corporations - Permissive Indemnification

The statute permits a corporation to indemnify a current or former director, officer, employee or agent of the corporation who was, is or is threatened to be a named defendant or respondent in a proceeding because the person is or was a director, officer, employee or agent if it is determined that the person:

- (i) conducted himself or herself in good faith, and
- (ii) reasonably believed
 - a. in the case of conduct in his or her official capacity, that his or her conduct was in the corporation's best interests, and
 - b. in all other cases, that his or her conduct was at least not opposed to the corporation's best interests.

In the case of criminal proceedings, the person also must have had no reasonable cause to believe that his or her conduct was unlawful. Indemnification is permitted for judgments, penalties, fines, settlements and reasonable expenses incurred by the person in connection with the proceedings. Where the proceeding was instituted by or on behalf of the corporation, indemnification is limited to expenses. Without such limitation, the judgment and indemnification would be circular.

Before an individual can be indemnified under the permissive indemnification provisions at least two separate steps must be taken. First, it must be determined if the person meets the standards articulated by the statute. For example, when considering whether a director is entitled to indemnification for expenses incurred in a civil proceeding arising out of conduct in the director's official capacity, it must be determined if the director acted in good faith and reasonably believed that his or her conduct was in the corporation's best interests. Nonprofit corporations should generally require that directors submit a written affirmation that they have satisfied these statutory requirements. Second, because permissive indemnification is by definition not mandatory, the corporation must take action to authorize the indemnification.

The Texas statute provides that the determination that indemnification is permissible may be made:

- (1) by a majority vote of a quorum of the board consisting of directors who at the time of the vote are not named defendants or respondents in the proceeding, or
- (2) if such a quorum cannot be obtained, by a majority vote of a committee of the board, designated to act in the matter by a majority vote of all directors, consisting solely of two or more directors who at the time of the vote are not named defendants or respondents in the proceeding.

Alternatively, the determination may be made by special legal counsel or by the corporation's members (if it has any) in a vote that excludes the vote of directors who are named defendants or respondents in the proceeding. If special legal counsel is retained for this purpose, such counsel must be selected by the board of directors or a committee thereof in the same manner in which the board or such a committee would be permitted to make the indemnification determination itself (as outlined above) unless a quorum of the board of directors consisting of directors who are not named defendants or respondents cannot be obtained and a committee consisting solely of two or more directors who are not named defendants or respondents cannot be established, in which case special legal counsel may be designated by a majority vote of all directors.

Once it has been determined that indemnification is permissible, indemnification must be expressly authorized. Authorization of indemnification must be made in the same manner as the determination that indemnification is permissible, except that if special legal counsel makes the determination that indemnification is permissible, authorization of indemnification must be made in the same manner as the special legal counsel was selected. With respect to the authorization of indemnification, the TNPCA further provides, however, that a provision contained in the articles of incorporation, the bylaws, a resolution of directors or an agreement that makes mandatory the indemnification permitted by the statute shall be deemed to constitute

authorization of indemnification in the manner required by the statute. This latter statutory provision may be important from a planning perspective. Where it is determined in advance that as a policy matter officers and directors should in all cases be indemnified to the maximum extent permitted, a provision may be inserted in the corporation's articles of incorporation or bylaws making mandatory the indemnification permitted by the statute.*

Indemnification is specifically prohibited, however, for obligations resulting from a proceeding in which a director has been found liable on the basis that a personal benefit was improperly received by the director, whether or not the benefit resulted from an action taken in the director's official capacity. In addition, indemnification is not permitted when the director is found liable to the corporation.

Finally, officers, employees and agents of the corporation who are not directors may be indemnified to such further extent as is provided by the corporation's articles of incorporation, its bylaws, action of its board of directors or contract or as permitted or required by law. Therefore, where it is determined that all or certain of such individuals should be indemnified, appropriate corporate action may be taken to put into effect the desired indemnification provisions.

Nonprofit Corporations - Advances of Expenses

One of the most significant changes in Texas nonprofit law was effected in 1985 by the enactment of the new indemnification sections which constituted a legislative overruling of a 1979 Texas case holding that indemnification was permissible only upon final disposition of a proceeding and that reimbursement of litigation expenses in advance of such disposition was improper. The revised Texas statute expressly authorizes reimbursement of expenses in advance of final disposition where:

- (1) a determination is made that the facts as then known to those making the indemnification determination would not preclude indemnification under the statute, and
- (2) the corporation receives from the person receiving the advance both:
 - a. a written affirmation by him/her of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification, and
 - b. a written undertaking by him/her or on his or her behalf to repay the amount paid or reimbursed if it is ultimately determined that he or she has not met those requirements.

The corporation may accept the written undertaking required by the statute without reference to the financial ability of the person receiving the advances to make repayment. In view of the staggering expenses that may be incurred in connection with complex litigation, this provision is of key importance and represents a dramatic improvement of the law prior to 1985.

* See the appendix for an example of such a provision.

A determination that expenses may be advanced and an authorization of such advances must be made in the same manner as specified by the statute for determining that indemnification is permissible. Thus, from a planning perspective, if it is deemed desirable to make mandatory this advancement of expenses in situations where it is permitted, an appropriate provision may be inserted into the articles or bylaws of the corporation.

Nonprofit Corporations - Insurance

The TNPCA specifically states that a nonprofit corporation may purchase and maintain insurance on behalf of any present or former director, officer, employee or agent. The insurance coverage may extend to any liability asserted against the director and incurred by the director in his or her capacity or arising out of the director serving in such capacity, whether or not the corporation would have the power to indemnify the director under the statute. This is an important provision of the law; unfortunately, the cost of such coverage has risen dramatically in the recent past, making coverage prohibitively expensive for many organizations.

If the nonprofit corporation is able to purchase insurance, then the directors should carefully review the scope of individuals covered by the policy. In particular, nonprofit corporations with advisory boards should ensure that the coverage is broad enough to include the advisory board.

Special Considerations for Private Foundations

A common question which arises in the administration and operation of private foundations is whether a private foundation may indemnify its directors and officers (referred to in this discussion as "Foundation Managers") for certain liabilities and expenses which they may incur in performance of their duties. Typically, the actions for which indemnification is sought are: (a) amounts paid pursuant to a judgment or a settlement with respect to an action brought against a Foundation Manager under state laws, (b) taxes, penalties or expenses of correction imposed upon a Foundation Manager with respect to violations of Chapter 42 of the Code, and (c) any expenses incurred with respect to the liabilities described in (a) and (b). Indemnification by a private foundation of a Foundation Manager with respect to these matters presents the following issues from a federal tax viewpoint. Will the indemnification by a private foundation of a Foundation Manager for any of the liabilities or expenses specified in (a), (b) and (c) above constitute (i) self-dealing as defined in section 4941 and/or (ii) a taxable expenditure as defined in section 4945? Alternatively, will the payment by a private foundation of premiums for liability insurance covering such matters constitute self-dealing or a taxable expenditure? General conclusions with respect to these issues are set forth below.

In connection with state and federal tax liabilities, indemnification payments by a private foundation to a Foundation Manager with respect to taxes, penalties or corrective acts imposed by Chapter 42 will constitute self-dealing under section 4941 and will be a taxable expenditure under section 4945. However, payment of premiums to purchase liability insurance will not be self-dealing or a taxable expenditure if the Foundation Manager's total compensation, taking into account his or her share of the premiums, is not excessive. With respect to expenses associated with state law and federal tax liabilities, indemnification by a private foundation of a Foundation

Manager's reasonable expenses with respect to the Foundation Manager's defense in a judicial or administrative proceeding involving Chapter 42 or state laws will not constitute self-dealing nor be a taxable expenditure if: (i) the expenses are reasonable, (ii) the Foundation Manager is successful in such defense or the proceeding is terminated by a settlement and (iii) at least with respect to Chapter 42 taxes, the Foundation Manager has not acted willfully and without reasonable cause. In addition, the payment of premiums for liability insurance in these instances will not be self-dealing or a taxable expenditure. However, the amount of the direct indemnification or the amount of the premiums must be included in a Foundation Manager's total compensation for the purposes of determining whether such compensation is excessive.

CHAPTER FIVE

GUIDELINES FOR RESPONSIBLE MANAGEMENT

The purpose of this booklet is to inform nonprofit organization officers and directors of their duties and of the potential liabilities for their failure to discharge such duties. It would be imprudent for any person to accept a position as a nonprofit organization director or officer without an understanding of these duties and liabilities. With an awareness of these duties and liabilities, however, these individuals, working together, can take certain steps to enhance their effectiveness in their managing capacities and to minimize their exposure to potential liabilities.

With respect to the duty of care, nonprofit corporation directors should exercise diligence in their attendance of meetings, failing to attend only when a valid excuse has been communicated to the corporation and placed in the record of the meeting. Directors should ensure that their decisions are based on adequate information. All available, relevant information should be considered and consideration should be given to retaining qualified experts for assistance in matters having a significant financial impact on the organization. On a periodic basis the director should review the organization's budget and financial statements, its compliance with applicable law and its fulfillment of its defined corporate purposes. Finally, the directors should exercise due care in their selection and supervision of officers, agents and committee members.

The composition and structure of the board and any board committees deserve special attention. The selection of directors who bring to the corporation only their high community profiles should be discouraged. Placing such individuals on the board is a dangerous practice both for the corporation and the individuals involved. Persons selected as directors should be those who will be diligent in the exercise of their duties and bring sound judgment to bear on the board's decisions. Where possible, a blend of relevant expertise and community representation should be reflected in the board's composition, and the selection of a significant number of independent directors who are not founding directors or members of the staff should be encouraged. It may be desirable to include an advisory board as a component of organizational structure. This body has no management function but may serve any or all of three significant purposes. First, if so structured, it may serve as a training ground for potential board members. Second, it is the appropriate body for those persons whose association with the organization is desirable because of a high community profile or other relevant attribute, but who can neither give the time nor accept the responsibility expected of members of a board of directors. Finally, an advisory board is a useful source of assistance to the organization where advisory board members sit on standing committees and are otherwise encouraged to involve themselves in the organization. There are several things a corporation can do to assist directors in their exercise of due care. First, it is imperative that candidates for director be informed of the organization's expectations of them. New directors should be given an orientation familiarizing them with the corporation's purpose, activities, its articles of incorporation and bylaws. Meetings should be scheduled well in advance, and an agenda and any relevant reports should be supplied to directors sufficiently in advance of the meeting to permit a thorough review. Directors should be supplied with as much relevant information as is practicable with respect to any decision they are asked to make, and they should be encouraged to ask questions of management. Financial statements should be made available to directors at least quarterly, and the director should be given the opportunity to

question the persons preparing the statements. Finally, the corporation should keep very complete minutes of all meetings of the board and its committees. With respect to the duty of loyalty, many organizations now request directors, officers and candidates for director to complete questionnaires disclosing all possible business and personal conflicts with the activities of the corporation. It is, of course, necessary to inform directors and officers of the corporation's significant activities if they are to know whether any of their activities might be viewed as a conflict. When considering an interested director or officer transaction, the interested director or officer should disclose to the board members the material facts concerning the director's interest in the transaction, which disclosure should be fully reflected in the minutes. An interested director should refrain from voting on the transaction, and all directors should be aware that, if challenged, the transaction will be subjected to the highest scrutiny. Therefore, care should be taken to ascertain that the transaction is on at least as favorable terms to the corporation as might be available from another source.

With respect to the duty of obedience, officers and directors should be familiar with the corporation's purposes and its powers, as embodied in its articles of incorporation. In addition, such individuals should remember that authority originates with the board and is only delegated to them by the bylaws or board resolutions.

Directors, officers, employees and agents engaged in fund- raising activities should take steps to ensure that any information pertaining to the corporation is truthful and complete. Directors should also be wary of making any representations about how specific funds or contributions will be handled other than in furtherance of the organization's overall charitable purposes. If event organizers or professional fundraisers are used, contingent fee agreements should be avoided.

Directors should also exercise caution in accepting donations subject to specific restrictions on use contained in the donor's will or gift instrument. These types of donations should be discussed with counsel.

The general concepts expressed above apply to trustees as well as officers and directors. Trustees should be intimately familiar with the provisions of the trust instrument and the Texas Trust Code.

Directors should be generally familiar with the basic statutory requirements and prohibitions applicable to their organization due to its nonprofit or charitable status for state law purposes and its private foundation/public charity status for federal income tax purposes. The advice of an attorney or accountant should be sought when necessary to ensure that the organization's tax status is not jeopardized and that taxes and penalties are not needlessly incurred.

Directors should be informed of the organization's policies and the provisions of its governing documents concerning indemnification and insurance. They should also be aware of the alternatives to those policies so that they can determine if that chosen is the most effective for the corporation.

It is TALA's experience that responsible management requires two ingredients: a structure that conforms to the purpose and activities of the organization and an informed and active

management. Where either ingredient is lacking the performance of the organization will suffer and potential liability will increase. If sound management guidelines are followed, however, assuming a leadership role in a charitable organization should be a fulfilling task that has a significant impact upon one's community. It is hoped that the material provided in this booklet will assist nonprofit directors in achieving such a goal.

APPENDIX

SAMPLE ARTICLES OF INCORPORATION PROVISIONS REGARDING INDEMNIFICATION AND INSURANCE

- A. The following provision does not override the provisions of Article 2.22A of the INPCA in any respect. The provision merely incorporates into the articles of incorporation or bylaws the provisions of the statute:

The Corporation shall indemnify directors and officers of the Corporation to the fullest extent required by Article 2.22A of the Texas Nonprofit Corporation Act and may indemnify directors, officers, employees and agents of the Corporation to the fullest extent permitted by Article 2.22A of the Texas Nonprofit Corporation Act. The Corporation shall have the power to purchase and maintain at its cost and expense insurance on behalf of its directors, officers, employees and agents to the fullest extent permitted by Article 2.22A of the Texas Nonprofit Corporation Act.

- B. The following articles of incorporation or bylaws provision reflects a decision to make indemnification and advancement of expenses mandatory to the fullest extent required or permitted by the statute:

The Corporation shall indemnify and advance reasonable expenses to directors, officers, employees and agents of the Corporation to the fullest extent required or permitted by Article 2.22A of the Texas Nonprofit Corporation Act. The Corporation shall have the power to purchase and maintain at its cost and expense insurance on behalf of such persons to the fullest extent permitted by Article 2.22A of the Texas Nonprofit Corporation Act.

- C. The following articles of incorporation or bylaws provision reflects a decision to prohibit indemnification in all situations, even those where indemnification would otherwise be mandatory under the statute:

The Corporation shall not indemnify or advance expenses to its directors, officers, employees or agents in any event.

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