

# THE FAKO AMERICA BOARD MEMBERS HANDBOOK



## RESPONSIBILITIES OF DIRECTORS OF THE FAKO AMERICA BOARD

<http://www.fakoamerica.org/>

July 2004

## **Table of Contents**

INTRODUCTION .....	3
VOLUNTEER BOARD MEMBERS OF ILLINOIS NOT-FOR-PROFIT ORGANIZATIONS .....	4
Volunteer Board Member Responsibilities .....	4
1. Be active .....	4
2. Receive no material profit .....	5
3. Avoid conflicts of interest .....	5
4. Exercise judgment in overseeing the organization's affairs .....	6
5. Comply with applicable governmental regulations .....	7
FIDUCIARY DUTIES OF NON-PROFIT BOARD MEMBERS .....	9
Overview .....	9
Fiduciary Duties of Directors .....	10
I. Fiduciary Duties of Directors under Illinois Common Law .....	10
II. Additional Fiduciary Duties of Directors of Charitable Corporations under Illinois Charitable Trust Law: .....	22
III. Fiduciary Standards for Directors of Charitable Corporations under the Federal Internal Revenue Code .....	25
IV. Litigation against Directors/ Breach of Fiduciary Duty .....	26
ADDITIONAL RESOURCES .....	32

## **INTRODUCTION**

One of the key requirements of *the Illinois General Not for Profit Corporation Act of 1986*, under which Fako America is incorporated, is that the association must have a Board to oversee its operations. To this end, the Illinois Attorney General's office provides a number of legal and ethical guidelines to assist Board members with the important responsibilities assumed when they volunteer their time.

In order to assist FA Board Members, I have put together a handbook containing some key information from the Attorney General's office. This handbook is primarily a guide and is not meant to prescribe the exact manner that Board members must act in all situations. This is because each organization possesses a distinct composition and experiences different circumstances and outcomes. Neither does it contain all of the provisions, exceptions, limitations and requirements of the law. These can be found in the Act of 1986. Nonetheless, the handbook is based on long-standing and widely accepted practices and common law principles governing Boards of Not-for-profit corporations.

The handbook is divided into Two parts: Part One outlines the fiduciary duties of Board members as defined by the Illinois Attorney General. Part Two consists of an article written by lawyers at the Illinois Charitable Trust Bureau that draws extensively from State and Federal case law to further explain the fiduciary duties of Board members of Illinois Not-for Profit Corporations. There is also a section that contains some important web resources for Board members

It is our hope that this handbook will always guide the actions of all Board Members and that it will serve as a valuable resource in case of any misunderstandings related to the Board's exact role. Thank you for your hard work and dedication to public service. Our association is a better place because of your volunteer efforts.

**Dibussi Tande**

**President, Fako America, 2002-2004**

## **VOLUNTEER BOARD MEMBERS OF ILLINOIS NOT-FOR-PROFIT ORGANIZATIONS**

Welcome, and thank you for volunteering to undertake this vital public service. Your gift of time and talent as a volunteer board member makes possible many important benefits to your fellow citizens. This information is intended only as a guide; specific legal questions should be directed to your attorney.

### ***Volunteer Board Member Responsibilities***

As a board member, you have the basic legal and policy responsibility for your not-for-profit organization. Even though you are an unpaid volunteer, you must:

1. [Be active](#)
2. [Receive no material profit](#)
3. [Avoid conflicts of interest](#)
4. [Exercise judgment in overseeing the organization's affairs](#)
5. [Comply with applicable governmental regulations](#)

The following information briefly describes your responsibilities as a volunteer board member. For additional information, contact your organization's lawyer or the **Office of the Attorney General at 100 W. Randolph St., Charitable Trust Bureau, 3rd Floor, Chicago, Illinois 60601, 312-814-2595 (TTY: 312-814-3374)**. Charitable Trust Bureau staff are eager to help you serve the public effectively.

### ***1. Be active***

You should attend meetings of the board and board committees on which you serve. You must have general knowledge and understanding of how the organization is functioning, and you must have particular knowledge and understanding about the purpose of the organization and the specific responsibilities assigned to you.

Absence from meetings and inactivity do not excuse you from legal responsibility.

[Back to Top of Page](#)

## **2. Receive no material profit**

Board members can only receive reimbursement for reasonable expenses and costs incurred in carrying out their board responsibilities. Illinois law prohibits loans by the organization to its directors and officers.

If a board member is also an employee, compensation can be paid but the employee/board member should not participate in setting his or her compensation.

[Back to Top of Page](#)

## **3. Avoid conflicts of interest**

As a board member, you owe a duty of loyalty to the organization that takes precedence over your personal interests.

- **Self-dealing**

Avoid transactions with the organization in which you have a personal or business interest beyond your interest as a board member. In the rare instance where it is not in the best interests of the organization to deal with you, you should make a full disclosure to the board of all the circumstances involved in the transaction, be sure that the transaction is fair to the organization, refrain from voting on the transaction as a board member, and not be counted in determining the existence of a board quorum. This restriction applies also to your relatives, business associates and friends.

- **Organizational opportunities**

In all matters pertaining to the organization, you must put its interests ahead of your own. If an opportunity related to the organization's purposes comes to you either as a board member or otherwise, you must make it available to the organization before you take it for yourself or another entity.

[Back to Top of Page](#)

#### **4. Exercise judgment in overseeing the organization's affairs**

As a board member, you have a duty to care for the organization's affairs in good faith and with at least the degree of diligence, care and skill which ordinarily prudent people would exercise under similar circumstances in like positions. Your good faith is not enough.

The board must act with knowledge and after adequate deliberation. The board must carefully set organizational policy and regularly oversee its administration by competent staff. To exercise its duty or care, the board must appoint and regularly review the chief administrative officer of the organization and establish and monitor, without getting involved in day-to-day activities, basic organizational policies and procedures as follows:

- Become familiar with all financial matters of the charity. Regularly request financial information and review all annual reports and audits of the organization's financial affairs. Each board member should be sure to review and keep copies of the returns filed with the Internal Revenue Service.
- Provide for competent legal counsel to assure compliance with applicable local, state and federal laws, including timely filing of reports and meeting procedures.
- Provide for regular meetings of the board and its committees with adequate reports on – and discussion of – organizational activities.
- Maintain adequate minutes of board and committee meetings as well as pertinent organizational records.
- Provide for careful selection and orientation of new board members.
- Be sure that conflicts of interest are avoided.
- Require board review, adoption and monitoring of the annual budget.
- Ensure financial resources to conduct organizational activities.
- Clarify and assure adherence to the purposes of the organization and monitor effectiveness in achieving results. A copy of the charter, by-laws and tax exemption letter, if any, will help with this.

- Assure a personnel program that provides competent staff.
- Assure that staff compensation and professional consulting fees are reasonable and set senior staff compensation.
- Provide sound investment and management of organizational funds and assets not expended directly for charitable purposes, to yield a reasonable return without undue risk.
- Protect the organization's property, including reasonable provision for safekeeping, replacement and divestment procedures that will benefit the organization.

[Back to Top of Page](#)

## **5. Comply with applicable governmental regulations**

A number of local, state and federal laws and regulations apply to not-for-profit organizations. The board is responsible for ensuring that the organization complies with these requirements.

- **Organizational regulations**

Illinois not-for-profit organizations may be organized either as not-for-profit corporations or as charitable trusts under a trust agreement. Not-for-profit corporations must file annual reports with the Illinois Secretary of State's office and annual financial reports with the Illinois Attorney General's office. Charitable trusts must file reports with the appropriate court and/or with the Illinois Attorney General's office.

- **Administration and solicitation of funds**

The Illinois Charitable Trusts Act and the Illinois Solicitation for Charity Act generally apply to charitable not-for-profit organizations functioning in Illinois whose assets exceed \$4,000 or who solicit or plan to solicit funds from persons in this state or from this state. Such organizations must register and then file annual reports with the Office of the Illinois Attorney General Lisa Madigan. The Attorney General is responsible for assuring that charitable funds are properly solicited and administered.

- **Taxation**

Some not-for-profit organizations are eligible for tax exempt status. Each exemption from income, real estate or sales tax requires a separate application. Most taxing authorities also require annual reports. Not-for-profit organizations are subject to all employer-employee taxes and regulations.

- **General regulations**

In conducting their operations, not-for-profit organizations are subject to most of the laws affecting individual and corporate conduct.

- **Accountability**

The Illinois Attorney General has the responsibility to the public of assuring sound and legal operation of not-for-profit organizations. This includes bringing legal action against board members for failure to exercise their legal responsibilities. Board members can be held personally liable by third parties injured by actions of the organization. Liability insurance for directors and officers is often available to cover some of these situations.

**Contact information:**

*Illinois Attorney General*  
*Charitable Trust Bureau*  
100 W. Randolph St., 3rd Floor  
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## **FIDUCIARY DUTIES OF NON-PROFIT BOARD MEMBERS**

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<http://www.cpaspi.org/cpaspi/resources/Fiduciary.pdf>

### **Overview**

The Board of Directors of a corporation, whether not-for-profit or for-profit are accountable generally for the overall management and direction of the corporation, including the oversight of the officers or the corporation, the method chosen to accomplish such and the reporting of results to the shareholders or other interested parties. A director, by and through the conduct of the entire board as a body, has the duty and responsibility to be the ultimate decision-making authority of a corporation. The Board of Directors may act through the delegation of responsibility and tasks, delegating specific duties to the chief executive officer, corporate board committees, and other corporate officers and agents, providing each with expressed and specific limited authority to handle the day-to-day operations and affairs of the corporation. However, the Board of Directors remains ultimately responsible for decisions effecting the overall corporate direction, as well as compensation and performance reviews of corporate officers, and the board has a duty to have a mechanism in place to oversee the activities and conduct of those to whom it has delegated powers and duties. The Board exercises its responsibility to supervise and monitor those to whom it has delegated authority by assuring that sufficient internal controls and management procedures are in place, and by taking steps to assure they are being followed and that proper audits are conducted.

### ***Fiduciary Duties of Directors***

Directors of Illinois charitable corporations have fiduciaries duties, parallel to those of for-profit directors and, arguably, additional heightened duties under the common law. The duties of a charitable corporation director come from at least four sources: (i) the common law; (ii) Illinois statutes governing charitable corporations; (iii) the Illinois Not-For-Profit Corporation Act; and (iv) the Federal Internal Revenue Code. In addition, new and evolving concepts of best practices and safe harbor conduct require directors to retain the advice of experienced professionals in the areas of audit, reporting and corporate law.

#### ***I. Fiduciary Duties of Directors under Illinois Common Law***

Generally - As a matter of Illinois law, directors of a corporation occupy a fiduciary relationship towards that corporation. (Shlenskvv. South ParkwavBuildingCorp., 191 11. 2d 268, 278 (1960); DixmoorGolf Club, Inc. v. Evans, 325 111. 612, 616 (1927).) In Dixmoor, the Supreme Court specifically held that:

"The directors of a corporation are trustees of its business and property for the collective body of stockholders in respect to such business. They are subject to the general rule, in regard to trusts and trustees, that they cannot, in their dealings with the business or property of the trust, use their relation to it for their own personal gain. It is their duty to administer the corporate affairs for the common benefit of all the stockholders, and exercise their best care, skill, and judgment in the management of the corporate business solely in the interest of the corporation." Dixmoor, 325 111. at 616.

**Common Law Fiduciary Duties** - The Directors of a charitable not-for-profit corporation have fiduciary duties of governance: (a) the duty of care and (b) the duty of loyalty. As a part of these duties directors are expected to perform by exercising informed knowledgeable participation. If a director breaches any of these duties, he/she can be removed from office and, depending upon rights of waiver and/or indemnification, held

subject to personal liability for any loss or harm to the corporation as a result of the breach.

**A. THE DUTY OF CARE**— This duty calls upon a director of a corporation (including a non-profit corporation) to act in a reasonable and informed manner when participating in the board's decisions and oversight of the corporation's management. A director should therefore be familiar with the corporation's governing instruments including its by-laws, board resolutions, and the Articles of Incorporation. These governing instruments set the framework under which a director's responsibilities and duties to the corporation exist. For example, a corporation's articles or by-laws may reserve specific functions exclusively for consideration of the Board of Directors or it may delegate certain functions to one or more corporate officer(s) and/or committee(s). The Board and each director should have a clear understanding of the role of, and extent of the powers granted to each corporate officer and each board committee in order to ensure a system of checks and balances where the Board maintains its integrity. Most importantly, the Board and its directors must keep in mind that while the officers and committees handle the day to day operations of the corporation, it is the Board that must decide policy and has a duty to have in place systems to safeguard the corporation by review of delegated authority to assure the best interest of the corporation.

In Citron v. Fairchild Camera & Instrument Corp., 569 A. 2d 53 (Del. 1989) the Delaware Supreme Court described the analysis often used to evaluate the duty of care of directors as follows:

"Our due care examination has focused on a board's decision-making process. We look for evidence as to whether aboard has acted in a deliberate and knowledgeable way in identifying and exploring alternatives. Within the context of this analysis, we are, of course, ever mindful of the realities of a corporate directorship. We recognize that management is often the catalyst in the decision-making process. We further recognize that aboard will receive substantial information from third party sources" (569 A. 2d at 66.)

1. **The Standard of Care**— The common law recognizes that the directors of a corporation should not be subject to liability for every routine business decision. As such, the duty of care requires directors to "act with the care that an ordinarily prudent person in a like position would exercise under similar circumstances." *Stamp v. Batastini*, 263 Ill. App. 3d 1010 (1st Dist. 1993); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). This duty necessarily requires Directors to act with:

**a) Good Faith** - No matter what, all directors have the obligation to act at all times in the best interest of the corporation when making corporate decisions. (*Anest v. Audio*, 332 Ill. App. 3d 469 (2nd Dist. 2002))

**b) Independent and Reasonable Judgment** - No director should defer judgment on any corporate issue to another. (i.e. vote solely on the basis of what another director thinks.) Instead, directors should use their own experience and background and evaluate for themselves any position taken by another director, an officer or staff member of the corporation, or an outside expert.

2. **Protection Afforded to Directors Who Satisfy Duty of Care:** As previously stated, directors who make a reasonably good-faith attempt to comply with the duty of care will be shielded from liability.

**a) Business Judgment Rule** - Under this legal doctrine, so long as the director acts upon an informed basis, in good faith, and in the honest belief that the action was taken in the best interest of the corporation, a rebuttal presumption arises that the decision was made with due care, and directors will not be held liable for losses to a corporation resulting from a Board decision. (*Stamp v. Touche Ross & Co.*, 263 Ill App. 3d 1010 (1st Dist. 1993); *Fields v. Sax*, 123 Ill. App. 3d 460 (1st Dist. 1984); *Lower v. Lanark Mutual Fire Insurance*, 114 Ill. App. 3d 462 (1st Dist. 1983)) (Note- if the

director has been found to have breach duty of care, the business judgment rule cannot apply.)

**1. Responsibility To Avoid Conflicts of Interest and Self-Dealing** - A conflict of interest occurs whenever there is a real or apparent incompatibility between one's private interests and one's fiduciary duties. Self-dealing occurs where a fiduciary engages in transactions with the assets or property over which he has a duty of care from which the fiduciary derives any benefit. (Holyoke v. Continental Illinois Nat. Bank & Trust Co., 346 Ill. App.284,292 (15<sup>th</sup> Dist.1952). The duty of loyalty requires that a director place the best interests of the corporation ahead of his/her personal interests. (Levy v. Markal Sales Corp., 28 Ill. App. 3d 355 (1St Dist. 1994); Forkin v. Cole, 192 Ill. App. 3d 409 (4<sup>th</sup> Dist. 1989); Weiss Medical Complex v. Kim, 87111. App. 3d 111 (1St Dist. 1989).) When a corporate director or officer does end up transacting business with his/her corporation, the transaction must be fair to the corporation, and the officer or director has the burden of demonstrating fairness if challenged. (Romanik v. Lurie Home Supply Center, Inc., 105 Ill. App. 3d 1118 (5<sup>th</sup> Dist. 1982).

**b) Delegation** - Because the Board of Directors does not manage the day-to-day affairs of the corporation, and instead delegates that function to managers, officers or employees, directors will not be held personally liable for actions or omissions of officers, employees, or agents as long as:

- i) such officers, employees and agents were prudently selected, based on experience and knowledge, and the directors reasonably relied on them to do their job; and
- ii) policies and procedures imposing internal controls to supervise and/or monitor the corporate officers, employees and agents were in place and regularly followed. (Lowell Hoit & Co. v. Detig et al., 320 Ill. App. 179 (2nd Dist. 1943).)

**c) Reliance** - The Illinois Not For Profit Corporations Act recognizes that a corporate director will for certain matters rely upon information from others. Directors are permitted to rely upon financial statements and data from corporate officers and employees (Section 105/108.65(c)). Directors may also rely upon professionals such as attorneys and Certified Public Accountants for relevant professional guidance (805 ILCS 105/108.65(c) (2000)). Note: A director will not be protected from liability if the director has personal knowledge that would make reliance on the information provided by others unwarranted. A director has a duty to share relevant facts and knowledge with the rest of the board.

**B. THE DUTY OF LOYALTY** — This duty requires directors to exercise their powers in good faith and in the best interests of the corporation, and prohibits directors from using their positions for individual personal advantage.

**a) Non-Participation** - The duty of loyalty requires that corporate directors who have a personal interest in a matter under consideration by the board to be disqualified from participating in any vote on the matter. The best practices process for a Board of Directors to take to protect against a director participating in a matter in which a conflict of interest exists is to exclude the self interested director from voting. A director with a conflict may be permitted to make a presentation to the Board, but when discussions and voting are occurring the self-interested person should be excluded. Those present should be directed not to reveal the vote, nor should the discussion remarks be reported to the interested director. (If a interested board member participates in the vote, even if there is a disinterested majority present and voting, the transaction is subject to being called to proof that it was fair and reasonable and in the best interest of the corporation. An examination of the each board member's knowledge about the details and alternatives related thereto makes them vulnerable to charges of breach and is certain to consume resources and time).

**b) Potential Self-Interested Transactions Include:**

- i) Sales or purchases between the corporation and a officer/director;
- ii) Usurpation of corporate opportunities - engaging in similar services as the corporation or with the corporations clients or customers;
- iii) High compensation matters , including, deferred compensation arrangements and pension plans;
- iv) Transactions with family of directors and officers;
- v) Insider trading or other misuse of corporate information;

**2. Usurpation Of A Corporate Opportunity** - The "corporate or business opportunity doctrine" prohibits a corporate fiduciary (including those serving on a not-for-profit board) from taking business opportunities that are developed by, belong to, or come to the possession and availability of the corporation. The duty of loyalty prohibits usurpation. Only if a corporation chooses not to use or take advantage of the opportunity can a corporate fiduciary then utilize the opportunity, and then subject to the following the fiduciary must: (a) fully disclose the opportunity to the corporate board; and (b) explain such and tender the opportunity to the corporation before he or she takes advantage of it (Anest v. Audio, 332 Ill. App. 3d 469 (2nd Dist. 2002); Dremco, Inc. v. South Chapel Hill Gardens, Inc., 274 Ill. App. 3d 534, 537 (1st Dist. 1995)). An "opportunity" to which the doctrine applies includes one not only within the corporation's current operations but also those developed through the use of corporate assets. (Forkin v. Cole, 192 Ill. App. 3d 409 (4th Dist. 1989); Graham v. Mimms, 111 Ill. App. 2d 751, 767 (1st Dist. 1982).) The good faith of the fiduciary is a factor in deciding whether usurpation occurred. (Lindenhurst Drubs, Inc. v. Becker, 154 Ill. App. 3d 61 (2nd Dist. 1987).)

**a) Forfeiture of all fees and compensation during period of breach -**

When a director commits a breach of his/her fiduciary duties of loyalty and fair dealing s/he forfeits any right to compensation during the period of her breach. (Veco Corp. v. Babcock, 243 Ill. App.3d 153, 165 (15<sup>th</sup> Dist. 1993); Vendo Co. v. Stoner, 58 Ill.2d 289, 314 (1974); see also Boston Children's Heart Foundation v. Nadal-Ginard, 73 F.3d 429 (15<sup>th</sup> Cir. 1996) (wherein the president of a nonprofit corporation conducting medical research in the field of cardiology was found to have forfeited any right to compensation during the period he was found to have engaged in self dealing and breach of fiduciary duty by failing to disclose to the board of the corporation that he was employed as an investigator with a medical institute at the same hospital where he performed services for the corporation, directing related work in cardiology and receiving a substantial salary. Notably, the court held that such forfeiture was proper even absent a showing of actual injury to the corporation.))

**b) Actual Damages caused by breach of duty -** A board member is personally liable for any losses occasioned by a violation of his/her duties as a fiduciary whether the loss was deliberate, a result of negligence, or mere lack of oversight by the fiduciary. (Stuart v. Continental Illinois National Bank and Trust Company of Chicago, 68 Ill.2d 502, 526 (1977).)

**3. Presumptions and Burden Shifting -** When a corporate director or officer transacts business with his/her corporation, the transaction must be fair to the corporation, and the officer or director has the burden of demonstrating fairness if challenged. The Supreme Court of Illinois has held that a breach of fiduciary duty is presumed whenever the fiduciary receives any benefits from his dealings on the beneficiary's behalf (Mors v. Peterson, 261 Ill. 532, 536 (1914)), and that in a transaction where the corporate fiduciary receives even a potential benefit, the fiduciary bears the burden



of proving affirmatively that the transaction was fair. (Winger v. Chicago City Bank and Trust Co., 394 Ill. 119, 110(1946); Romanik v. Lurie Home Supply Center, Inc., 105 Ill. App. 3d 1118 (5<sup>th</sup> Dist. 1982); see also, Graham v. Mimms, 111 Ill. App. 2d 751, 766-67 (15<sup>th</sup> Dist. 1982).)

**4. Penalties for Breach of Duty of Loyalty at Common Law:** Forfeiture, Damages, and holding the entire transaction void. (Boston Children's Heart Foundation v. Nadal-Ginard, 73 F.3d 429 (15<sup>th</sup> Cir. 1996) (Massachusetts Case).)

**c) Holding Transaction Void** - Under the common law, transactions involving a breach of a director's duty of loyalty may render the entire transaction void. (Romanik v. Lurie Home Supply Center, Inc., 105 Ill. App. 3d 1118 (5<sup>th</sup> Dist. 1982); Cook County v. Barrett, 36 Ill. App. 3d 623 (15<sup>th</sup> Dist. 1976).)

**d) Constructive Trust** - A "constructive trust" is a remedy imposed by a court to prevent a person from holding, for his own benefit, assets which he has gained by taking advantage of a fiduciary relationship or through a breach of fiduciary duty. (Anderson v. Lybeck, 15 Ill. 2d 227, 232 (1958); Frederickson v. Blumenthal, 271 Ill. App. 3d 738, 742 (15<sup>th</sup> Dist. 1995).) Any corporate assets taken, along with their fruits and proceeds are deemed by law to belong to the corporation and must be returned.

## **5. Safe Harbor Statutes**

**a) The Illinois Not For Profit Corporation Act** - provides statutory "safe harbors" that allow a transaction between a corporation and its fiduciary to be presumed valid rather than invalid. See: Section 105/108.60 of the Illinois Not-For-Profit Corporation Act). In general, a self interested transaction between an officer/director and the corporation will be allowed as a safe harbor, if as a predicate full disclosure of all material facts is

provided to the board so that a disinterested body of the board is fully informed and either: (i) the transaction is approved by informed, disinterested directors; or (ii) the transaction is ultimately demonstrated to be fair to the corporation. (See 805 ILCS 105/108.60 (2000).)

**b) The Internal Revenue Code** - Intermediate Sanctions at Internal Revenue Code Section 4958 is applicable to 501(c) 3 charitable organizations and prohibits self-interested and excessive compensation transactions through threat of large tax penalty against both the charitable entity and the fiduciary. IRC Section 4958 was enacted to impose penalty excise taxes as "intermediate" sanctions in cases where organizations exempt from tax under section 503 (c) engage in "excess benefit transactions. An excess benefit transaction is one in which a tax-exempt organization provides an economic benefit to one or more of the organization's insiders, called "disqualified persons", if the fair market value of the benefit exceeds the value of what the organization receives in return. Sec. 4958(c)(1)(A); Disqualified persons include not only those who are able to exercise substantial influence over the tax-exempt organization, but also their family members and entities in which those individuals have 35 percent of the voting power. Disqualified persons are subject to the excise penalties, whether the excess benefit transactions are accomplished "directly or indirectly." Sec. 4958(c). A disqualified person who receives an excess benefit from an excess benefit transaction is liable for an initial excise tax equal to 25 percent of the excess benefit. Sec. 4958(a)(1). If the initial tax is imposed and the transaction is not corrected within the taxable period, then the disqualified person is liable for an additional tax of 200 percent of the excess benefit. Sec. 4958(b). The regulations associated with this code section provide safe harbor directives for boards to follow to avoid triggering the Code section. Thus, within its provisions Section 4958 provides its own safe harbor conduct to guide fiduciaries to avoid such penalties in self-interested transactions and high

compensation arrangements. The safe harbor requirements generally are similar to those provided under state statutory law, including abstaining from self-benefiting voting. The safe harbors allow boards to hire and rely upon professional advice and/or guidance when dealing with high compensation or self-interested matters. While this section was enacted in 1995, the regulations were delayed in issuance, and the full impact of this section has not been fully resolved. However guidance of what can be expected comes from a recent tax court decision under this code section. In CARACCI v. COMMISSIONER OF INTERNAL REVENUE, 118 T.C. 379 (2002), the petitioners, the Caracci family members, purchased the assets of several charitable companies they had operated upon valuations and methods of value the IRS and the tax court determined to be biased and not independent. The tax court found the fair market value of assets transferred to the self interested fiduciaries to be valued at \$18,675,000, while the amount paid by the fiduciaries in the form of assumed liabilities was \$13,511,000, the court finding the excess benefit to the fiduciaries was in excess of \$5,164,000 joint and severally, there being no evidence the petitioners had acted to invoke any safe harbors, the court upheld an assessment of penalties and tax in excess of \$3 7 million against each of the petitioners, totaling tax and penalties in excess of \$250 million. The tax court explained the basic mechanics of the code section were violated holding as follows:

"Here, the fair. market value of the Sta-Home tax-exempt entities' transferred assets far exceeded the consideration paid by the Sta- Home for-profit entities. Thus, the asset transfers were excess benefit transactions which directly benefited the transferees (i.e., the Sta-Home for profit entities) and indirectly benefited the Sta-Home for-profit entities' shareholders (i.e., the Caracci family members). Petitioners do not seriously dispute that they are disqualified persons with respect to the Sta-Home tax- exempt entities. Joyce P. Caracci, Michael Caracci, and Christina C. McQuillen, as directors and officers of each of the three Sta-

Home tax-exempt entities, are disqualified persons because they were in positions to exercise substantial influence over the entities' affairs. Sec. 4958(f)(1)(A). Victor Caracci and Vincent Caracci are disqualified persons because of their familial relationships to Joyce P. Caracci, Michael Caracci, and Christina C. McQuillen. Sec. 4958(f)(1)(B).... Accordingly, petitioners are subject to excess benefit taxes under section 4958"... We conclude that each of the disqualified person/petitioners is jointly and severally liable for the initial and additional taxes under section 4958(a)(1) and (b) as to the excess benefits. The effect of our holding is

that the individual petitioners are jointly and severally liable for the total excess benefit of \$5,164,000."

**c) Exceptions - Private Foundations** - Irrespective of safe harbors "private foundations" are prohibited from certain self-dealing transactions under any circumstances under the Internal Revenue Code at Section 4941. Illinois law also expressly requires adherence to the Internal Revenue Code prohibitions against self-dealing applicable to private foundations (See: 760 ILCS 60/1; See IRC 4947; 805 ILCS 105/103.12).

**C. INFORMED KNOWLEDGEABLE PARTICIPATION AND BEST PRACTICES** —

In order to satisfy the above-stated duties, directors must actively educate themselves regarding corporate affairs and participate in making corporate decisions.

**1. A Director Has An Obligation To Be Informed** - Knowing the business of the corporation, the corporation's finances, the compensation of high-level employees, the details of how the corporation delegates authority, and the corporate purposes is part of a board member performing his/her duties.

**a) Documents Which Directors Should Be Provided To Be Informed -**

Directors should be provided with a copy of the corporation's Articles of Incorporation and By-Laws, as well as copies of board minutes, resolutions, committee minutes, consultant reports, budgets, fund-raiser contracts, executive compensation committee minutes, executive compensation contracts, consultant reports on executive compensation, treasurer reports, the corporation's most current audited financial statement, audit opinion letter from a Certified Public Accountant, and the corporation's most recent Federal Form 990 tax report and/or other tax form;

**b) Directors Need to Ask Questions -** A director should ask questions, especially if he/she is not familiar with a topic being discussed and needs more facts, or if he/she does not understand the need for corporate action and requires more information. In no event should a decision be made before the directors reasonably understand the need for corporate action, the possible courses of action available, and the potential consequences of selecting one course of action over another. Directors may not close their eyes to what is going on about them in the corporate business. (Stamp v. Touche Ross & Co., 263 Ill App. 3d 1010 (1<sup>st</sup> Dist.1993); Fields v. Sax, 123 Ill. App. 3d 460 (1<sup>st</sup> Dist. 1984).) If a director lacks adequate information sufficient to make an educated decision, additional information should be obtained to clarify the issues and aid in

**a) Directors Should Participate in Setting Meeting Agenda** - Directors should participate in deciding when and where a meeting should be held, and what should be discussed. They should not leave those decisions up to the President or CEO of the corporation. However, because the Board has delegated the running of the corporation's day to day needs to the President or CEO, it is important for the Board to give those officers a full opportunity to place matters on the agenda at meetings convenient to the business of the corporation.

**b) Directors Should Regularly Attend And Vote at Board Meetings** - A Director will be protected from liability under the business judgment rule only if he/she is shown to have acted in good faith in the best interest of the corporation, which includes regular attendance and active participation in the decision making of the corporation.

understanding. (Stamp v. Touche Ross & Co., 263 Ill App. 3d 1010 (1st Dist. 1993).);

**2. A Director Also Has An Obligation to Participate** - A Board of Directors should always recognize the fact that it, the Board, and not the chief executive officer or its management committee, is the governing body of the corporation. The place, manner, and method of meeting are, therefore, for the Board of Directors to decide. Directors should not allow themselves to be placed or in a position where they feel as though they are attending a meeting as a guest of the president/executive director.

## ***II. Additional Fiduciary Duties of Directors of Charitable Corporations under Illinois Charitable Trust Law:***

In addition to the duties of loyalty and care as expressed above, in Illinois, directors of a charitable not for-profit corporation are bound by additional

common law and statutory duties, including a duty to carefully maintain and manage the property of the corporation and to conform to the actions of the corporation to its charitable purposes as expressed in the corporation's governing documents, e.g. Articles of Incorporation and By-Laws. (Trustees of Dartmouth College v. Woodward, 17 U.S. 518,4 L.Ed 629 (1817); see Am. Jur.2d, Charities § 98.) Under Illinois law, directors and officers of a charitable corporation are trustees of the corporation and all of its assets and property. Both the Illinois Charitable Trust Act, 760 ILCS 55/1 et seq. (1999), and the Illinois Solicitation or Charity Act, 225 ILCS 460/1 et sg. (1999) define a charitable "trustee" to include any officer, director, executive director or other controlling persons of a corporation soliciting or holding property for a charitable purpose.

Section 15 of the Trust Act in turn sets forth fiduciary duties and responsibilities which are imposed upon charitable trustees by law, stating as follows:

*"Sec. 15.*

*(a) Charitable trustees are subject to certain duties otherwise defined in Illinois statutes and case law, which include but are not limited to the following: (1) To avoid "self-dealing" and conflicts of interest;*

- 1) To avoid "self-dealing" and conflicts of interest;*
- 2) To avoid wasting charitable assets;*
- 3) To avoid incurring penalties, fines, and unnecessary taxes;*
- 4) To adhere and conform the charitable organization to its charitable purpose;*
- 5) To not make non program loans, gifts, or advances to any person, except as allowed by the General Not For Profit Corporation Act of 1986 [805 ILCS 105/101.01 et seq.];*
- 6) To utilize the trust in conformity with its purposes for the best interest*

*of the beneficiaries;*

*7) To timely file registration and financial reports required by this*

*Act; and*

*8) To comply and to cause the charitable organization to comply with this Act and, if incorporated, the General Not For Profit Corporation Act of 1986 [805 ILCS 105/101.01 et seq.].*

**(760 ILCS 55/15(a) (1999).)**

The common law also imposes the duty on charitable trustees in their "administering of the charitable trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property." IIA Scott on Trusts § 174 (4<sup>th</sup> ed.1982).

Unlike the "business judgment rule" which creates a presumption that directors of for-profit corporations act with care, charitable trustees are required to act under a much higher standard of care, and in some circumstances may be held liable for simple negligence. Moreover, the trustees of a charitable corporation owe an absolute duty of loyalty to the corporation. The duty of loyalty of charitable trustees was summarized by Judge Cardozo in the New York case of Meinhard v. Salmon, 164 N.E.2d 545, 547 (N.Y. Ct. App. 1929) as follows:

"Many forms of conduct permissible in a workday world for those acting at arms' length, are forbidden by those bound by fiduciary ties. A trustee is held, to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty."



### **III. Fiduciary Standards for Directors of Charitable Corporations under the Federal Internal Revenue Code**

The Internal Revenue Service requires that tax-exempt charitable corporations strictly adhere to the provisions of Section 501(c)(3) of the Internal Revenue Code. A violation of these standards can result in forfeiture of a corporation's tax-exempt status and the loss of the ability of donors to be able to deduct contributions to the corporation under Section 170 of the Internal Revenue Code. To qualify as a Section 501(c)(3) Tax-Exempt Organization, "no part of the net earnings of (the corporation) inures to the benefit of any shareholder or individual." Violation of the "private inurement" prohibition is grounds for the loss of tax exempt status. (See Foundation Church of Scientology v. United States, 412 F. 2d 1197 (Ct. CI 1969), cert. denied, 397 U.S. 1009 (1970).)

Section 501(b) of the Internal Revenue Code denies tax exempt status to organizations that have engaged in "prohibited transactions", which include:

- (a) Lending money without adequate security;
- (b) Paying excessive compensation to directors; and
- (c) Providing preferential services to a controlling person or substantial contributors.

In addition to losing the corporation's tax-exempt status, actions by directors that lead to "private inurement" and "self dealing" transactions can also result in the imposition of penalties. Section 4958 of the Internal Revenue Code imposes a penalty excise tax on Section 501 (c)(3) and Section 501 (c)(4) insiders who engage in "excess benefit transactions." Under the Code, an insider includes any individual who benefits from such transactions and any managers of the organization who knowingly engage in such transactions. The list of excess benefit transactions include:

- (a) non-fair market value transactions;
- (b) unreasonable compensation; and
- (c) revenue sharing arrangements that violate the "private inurement" prohibition.

Safe Harbor Provisions- Under the Internal Revenue Code, a corporate director can escape sanctions if he/she has conformed to a standard of conduct that requires directors to be informed, seek professional guidance and perform their fiduciary duties and avoid participation in self-dealing transactions.

#### ***IV. Litigation against Directors/ Breach of Fiduciary Duty***

**A. Limited Liability For Unpaid Directors** - The Illinois Not For Profit Corporations Act provides that an uncompensated director of an Illinois nonprofit corporation is not liable for any damages resulting from any act or omission or from the exercise of his/her judgment in connection with his/her role as director unless the act or omission involved was willful or wanton. (805 ILCS 105/108.70 (2002).) As a consequence, under this section of the Act, no cause of action can be brought against an uncompensated director individually for negligence. This section, however, does not immunize the corporation from liability for the negligent acts or omissions of its directors.

**B. Limits On Waiver of Liability for Negligent Actions of Directors** - While Illinois statutory law does permit an Illinois corporation to "waive" liability for the negligent actions of its directors relative to the duty of care, such liability waiver provisions have limits and do not necessarily protect directors if they breach their duty of loyalty or good faith. Case law for Illinois not-for-profit corporations has not fully developed in this area. However the provisions available for Illinois for-profit corporate director waivers of liability under the Business Corporation Act (805 ILCS 5/2.10) and those for not-for-profit corporate directors waivers of liability under the relevant act (805 ILCS 105/108.70) have similarities. Illinois for-profit corporation director liability waivers are inapplicable "(i) for any breach of the director's duty of loyalty to the corporation or its shareholders, (ii) for acts or omissions not in good faith or that involve

intentional misconduct or a knowing violation of law, (iii) under Section 8.65 of this Act, or (iv) for any transaction from which the director derived an improper personal benefit. "(805 ILCS 5/2.10). Illinois Not For profit corporation directors liability waivers fail if the breach" involved willful or wanton conduct" and they also fail if the director is paid. (805 ILCS 105/108.70)

In this area guidance may be obtained from looking at Illinois for-profit corporation law. Noteworthy in determining what conduct is shielded by the liability waiver sections of the Illinois corporate statutes is the recent 2003 decision in In Re Abbott Laboratories Derivative, 325 F.3d 795, 811(7<sup>th</sup> Circuit, 2003). In Abbott, the 7<sup>th</sup> Circuit applying Delaware law to an Illinois corporation upheld the general rule:"... where the plaintiffs allege only a breach of the duty of care, with no claims of" bad faith, intentional misconduct, knowing violation of law, or any other conduct for which the directors maybe liable," the waiver provision maybe considered and applied in deciding a motion to dismiss. Also Illinois corporation law generally follows Delaware law See: Aronson v. Lewis 473 A.2d 805 (Del.1984)).

However, the Abbott court provides that directors are not protected under a statutory waiver of liability provision when a complaint alleges facts that infer a breach of loyalty or good faith. The Abbott court found allegations of "omissions not in good faith" and "intentional misconduct" concerning "violations of law," to allege conduct which falls outside of the statutory liability waiver exemption". The Abbott Court citing McCall v. Scott, 239 F.3d 808 (6<sup>th</sup> Cir.2001), amended on denial of rehearing by McCall v. Scott, 250 F.3d 997 (6<sup>th</sup> Cir.2001), indicates directors" 'unconsidered inaction," in the face of significant disclosed issues (directors' failure to act in the face of audit information, ongoing acquisition practices, allegations brought against the corporation in a qui tam action, a federal

investigation, and an investigation by the NEW YORK TIMES into the company's billing practices) equates to "intentional or reckless disregard", in which the statutory waiver would not protect a director from charges of breach of duty by lack of good faith. The court stated "the magnitude and duration of the alleged wrongdoing is relevant in determining whether the failure of the directors to act constitutes a lack of good faith." Id. at 823. In addition, the Abbott court further held that while breach of "duty of care claims alleging only grossly negligent conduct are precluded by (statutory waiver of liability) provisions"..."(breach of) duty of care claims based on reckless or intentional misconduct are not." 250 F.3d at 1000. In Abbott again citing McCall the court noted "Under Delaware law, the duty of good faith maybe breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer." The Abbott court then applied such to an Illinois corporation, holding that "conscious disregard of known risks,... cannot have been undertaken in good faith and claims alleging such will not be precluded by (statutory waiver of liability) provision." (Abbott, 325 F.3d 811). The "willful and wanton" conduct set forth in the Illinois Not For Profit Corporation Act is defined to include "an utter indifference to or conscious disregard"(805 ILCS 105/108.70(d)). The Abbott court's holding that "unconsidered inaction" on substantial informed matters equates to "intentional or reckless disregard" and that cases brought on directors acts of "conscious disregard of known risks,... cannot have been undertaken in good faith and...(will) not be precluded by [the company]'s (statutory waiver of liability)", suggest that directors of not-for-profit corporations are subject to liability for breaches of duty of loyalty and good faith.

**C. Indemnification By The Not-For-Profit Coloration** - A not-for-profit corporation may indemnify an officer or director against reasonable legal expenses incurred by him/her, judgments and fines imposed on him/her, and/or amounts which he/she may have paid in settlement arising out of any

civil or criminal litigation brought against him/her, if the officer or director acted in good faith.

1. Indemnification under the Not For Profit Corporations Act 805 ILCS 105/108.75- (a) Section 105/108.75 (a) of the Illinois Not For Profit Corporations Act provides that a not-for profit corporation may indemnify an officer or director for all reasonable legal expenses, judgments, fines, and amounts paid in settlement for any civil or criminal action filed against him/her for acts taken as an officer or director of the corporation if

(i) There is no finding that the officer or director acted in bad faith,  
and

(ii) The officer or director reasonably believed he/she acted in the best interest of the corporation;

(805 ILCS 105/108.75(a) (2000).)

b) Section 105/108.75(b) of the Illinois Not For Profit Corporations Act provides that a not-for-profit corporation may indemnify an officer or director for all reasonable legal expenses, judgments, fines, and amounts paid in settlement for any action brought by or in behalf of the corporation if

(i) There is no finding that the officer or director acted in bad faith,  
and

(ii) The officer or director reasonably believed he/she acted in the best interest of the corporation, and

(iii) There was no adjudication of negligence or misconduct in the performance of his/her duty to the corporation.

(805 ILCS 105/108:75(b) (2000).)

c) Section 105/108.75(c) of the Illinois Not For Profit Corporations Act provides a not-for-profit corporation has a duty to indemnify an officer or director for the reasonable legal expenses, judgments, fines, and amounts paid in settlement as described in 108.75(a) and (b) above, if the officer or director is successful on the merits of or in his defense of the case against him.

(805 ILCS 105/108.75(c) (2000).)

d) Section 105/108.75(e) of the Illinois Not For Profit Corporations Act provides that a the nonprofit corporation has the right to advance expenses incurred by a director in defending a civil or criminal suit.

(805 ILCS 105/108.75(e) (2000).)

e) Section 105/108.75 (f) of the Illinois Not For Profit Corporations Act provides that rights to indemnification as provided under Section 105/108.75 as stated, are not exclusive, and that a nonprofit corporation may provide more extensive rights to its directors and officers if its decides to do so.

(805 ILCS 105/108.75(f) (2000).)

f) Section 105/108.75 (g) of the Illinois Not For Profit Corporations Act provides that a nonprofit corporation may purchase and maintain liability insurance coverage on behalf of any of its directors, officers, employees, and agents.

(805 ILCS 105/108.75(g) (2000).)

g) It is important to note that in any resolution of charges against an officer and/or a director the issue of whether or not there was negligence or misconduct in the performance of his/her duty to the corporation, bad faith and/or conduct not in the best interest of the corporation should be set forth in the findings of an order, and/or a settlement agreement, and not left unresolved, because if the order or settlement is predicated upon wrongdoing, the failure to include the appropriate language can result in an entitlement to attorney fees:

i) That under Section 105/108.75 (a) and 105/108.75(b) above, if a director or officer enters into a plea agreement, consent decree or settlement of a lawsuit, that act, does not, of itself, create a presumption of bad faith or that the officer or director of the corporation did not reasonably believe that he/she acted in the best interest of the corporation. As such, if a corporation's by-laws provide for indemnification it would be required to indemnify the officer or director if he/she settles an action and bad faith is not implicated. Thus, concern for settlement terms must directly address the issue of bad faith and whether the conduct was in the best interest of the corporation, consider attorney fee responsibilities and the terms of a settlement adjusted to achieve the result expected by the parties.

ii) Also under Section 105/108.75(b) above, if the corporation brings an action against its own director or officer, and a settlement is reached, the director or officer may still be able to petition the Court for indemnification, and if the court deems it reasonable, can force the corporation to indemnify for all expenses incurred by the director or officer.

## **ADDITIONAL RESOURCES**

In carrying out their responsibilities, board members should realize that they need not do it alone. There are many resources available to assist not-for-profit organizations in fulfilling their fiduciary duties. Following are some of those resources:

### **The Minnesota Council on NonProfits (MCN) [www.mncn.org](http://www.mncn.org)**

MCN is a membership association of over 1300 Minnesota nonprofit organizations that shares information, services and research to educate its members and the community. The “Info Central” section of its web site - [www.mncn.org/infocentral.htm](http://www.mncn.org/infocentral.htm) - contains information of interest to not-for-profit organizations regardless of their state of formation or location.

### **NASCOnet.org - [www.nasconet.org](http://www.nasconet.org)**

This site is maintained by the National Association of State Charity Officials (NASCO). NASCO members are employees of state agencies that regulate not-for-profit organizations and their fund raisers. The site provides information concerning the registration and reporting requirements applicable to not-for-profits that conduct activities and/or raise funds in the various states.

### **The Internal Revenue Service - [www.irs.gov](http://www.irs.gov)**

Posts all of its forms and instructions and many brochures drafted to assist not-for-profit boards in completing their annual financial filings with the IRS and in carrying out their other responsibilities. If you can't find the information that you want on the IRS web site, call its toll-free number - 1-877-829-5500 - set up especially for those who have questions about tax-exemption and tax-exempt organizations.

### **Alliance for NonProfit Governance (ANG)- [www.ang.org](http://www.ang.org)**

ANG is an organization whose purpose is to encourage and promote good governance in the nonprofit sector. Its web site posts information on good governance, links to other sites of interest to not-for-profit boards and information about courses and conferences for nonprofit board members.



**Alliance for Nonprofit Management** - [www.allianceonline.org](http://www.allianceonline.org)

The Alliance for Nonprofit Management is a professional association of individuals and organizations whose mission is improve the management and governance capacity of nonprofits. Its web site includes information about resources available to not-for-profit organizations.

**American Institute of Certified Public Accountants (AICPA)** - [www.aicpa.org](http://www.aicpa.org)

The AICPA's web site has extensive information on accounting standards and procedures. It is a valuable source of a wide variety of information on accounting issues for board members.

**Board Café** - [www.compasspoint.org](http://www.compasspoint.org)

Board Café is an electronic newsletter for members of nonprofit boards of directors. Board Café offers a menu of ideas, information, opinion, news, and resources to help board members in carrying out the responsibilities of their board service.

**BoardSource, Inc.** - [www.boardsource.org](http://www.boardsource.org)

Has a wide range of material designed to assist board members in carrying out their duties. Its nine pamphlet "Governance Series", beginning with *Ten Basic Responsibilities of Nonprofit Boards*, is a source of basic information for board members and includes other suggested resources.

**Council on Foundations** - [www.cof.org](http://www.cof.org)

The Council on Foundations is a membership organization of more than 2,000 grant making foundations and giving programs worldwide. It provides leadership expertise, legal services and networking opportunities, among other services, to its members and to the general public. Its web site contains information of interest to not-for-profit boards.

**The Foundation Center** – [www.fdncenter.org](http://www.fdncenter.org)

The Foundation Center's mission is to strengthen the nonprofit sector by advancing knowledge about U.S. philanthropy. It collects, organizes and communicates information on U.S. philanthropy, conducts and facilitates research on trends in the field, provides education and training on the grant seeking process and promotes public access to information and services through its web site and print and electronic publications and five library/learning centers.

**GuideStar** - [www.guidestar.org](http://www.guidestar.org)

GuideStar is a national database of that posts financial reports and other information on over 850,000 tax-exempt U.S. charitable organizations on its web site. It is a source of information about the operations and finances of nonprofit organizations.

**Volunteer Consulting Group (VCG)** - [www.boardnetUSA.org](http://www.boardnetUSA.org)

VCG is a nonprofit organization whose mission is to strengthen the governing and management capability of nonprofit boards of directors by bringing qualified leadership into service as board members. VCG assists boards in defining their board recruitment objectives and then conducting a targeted search for business, professional and community leaders with the desired expertise, diversity of perspective and resources. VCG's web site is a resource designed to enable potential board members--and nonprofit boards needing leadership--to find each other.

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