HOW TO BE AN EFFECTIVE ASSOCIATION DIRECTOR (WITHOUT BEING SUED)

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CONTENTS

I. How to be an Effective Association Director

A. The Director's Role In Governance and Operations

B. How To Exercise Effective Oversight

1. Act in Good Faith
2. Adhere to the Association's Mission
3. Attend Meetings
4. Monitor the Association's Finances
5. Delegate, Do Not Abdicate
6. Be Reasonably Informed
7. Take Corrective Action When Necessary
8. Invest the Association's Money Prudently
9. Rely on Advisors
10. Safeguard Assets
11. Avoid Conflicts of Interest
12. Maintain Confidentiality

II. How to Avoid Being Sued

A. Introduction

B. Common Reasons Association Directors Are Sued

1. Neglect
2. Bad Business Decisions
3. Violating Articles of Incorporation or Bylaws
4. Breaking the Law
5. Insider Transactions
6. Lack of Fair Dealing With Members
7. Defamation

8. Wrongful Discharge
9. Negligent Investment of Association Funds
10. Failure to Protect Association Property
11. Usurping a Corporate Opportunity
12. Breach of Contract

III. Other Means of Protection

A. Volunteer Protection Statutes
B Indemnification
C. Directors and Officers Liability Issuance

I. HOW TO BE AN EFFECTIVE ASSOCIATION DIRECTOR

A. The Director's Role in Association Governance and Operations

It is important for association Directors to understand their role in the association's governance and operational structure. It is often said that the Board has ultimate *responsibility* for the association, but that is inaccurate. Granted, the Board of Directors has ultimate *authority* within the association, and it must exercise that authority responsibly, but Directors are not expected to be, nor should they be, involved in the day-to-day management of the association. The Board's role "[does not include] direct operational responsibilities." *Revised Model Nonprofit Corporation Act.*

An association Board's role "is limited to overseeing operations," not "operat[ing] the corporation on a day-to-day basis." *ABA Guidebook for Nonprofit Directors.* "The board should be in the position of being an effective overseer of corporate operations—not to micro-manage such operations but to exercise a more in-depth, informed, and objective oversight role." *ABA Coordinating Committee on Nonprofit Governance.*

B. How To Exercise Effective Oversight

If the job of an association Director is to oversee the functioning of the association, how exactly

does he or she accomplish that function? It is not exceedingly difficult. Here is how:

1. Act in Good Faith

Above all else, an association Director should carry out his or her duties in good faith, i.e., with an intent to advance the best interests of the association. Directors may differ in their opinions as to what those best interests are, but they should never waiver from this principle.

2. Adhere to the Association's Mission

An important guidepost for any Board decision is whether the proposed action is consistent with the mission of the association.

3. Attend Meetings

It may seem obvious to most, but it is worth stating that Directors must attend Board meetings. Certainly there may be business or personal matters that cause a Director to miss an occasional meeting, and that is fine. But there is no recognition in the law of so-called "figure head Directors" or "dummy Directors," and courts will have no sympathy for Directors who claim as a defense to any legal action that they did not know of a particular issue or did not participate in a particular action because of *repeated* failures to attend meetings. In fact, the act of failing to attend meetings may itself be deemed to be negligent behavior.

4. Monitor Association Finances

This too may be apparent, but some number of nonprofits fail every year, many because the Board was not paying attention, or was reckless, or made ill-informed decisions.

Arguably the most important action that an association Board will take is approval of the annual budget. The budget represents the Board's position on how the association's financial resources are to be spent, and what activities the association should depend on to generate necessary revenue.

Board members should expect that timely and adequate income and expense statements, balance sheets, and budget status reports will be provided, and should expect to receive these in advance of Board meetings. Funds permitting, the Board also should have a regular outside audit of the association's finances and should review the auditor's report at a meeting with the auditor.

A Board should ensure that the association has adequate internal accounting systems and controls.

5. Delegate, Do Not Abdicate

While the Board of Directors makes the important policy decisions that guide and determine the activities of the association, it typically must rely on others to carry out those decisions, primarily the association staff. Boards also delegate their duties to

committees and outside consultants and advisors as well. Such delegation is entirely acceptable under the law, and, in fact, a Board could not operate in any other manner. But a Board of Directors cannot completely abdicate its duties. That is, a Board must monitor those to whom it has delegated certain authority to ensure that such persons are acting responsibly.

This monitoring usually takes the form of regular reporting to the Board from those persons to whom authority and tasks have been delegated.

6. Be Reasonably Informed

A Director has a duty to be informed. According to the so-called “business judgment rule”, members of association Boards will not, generally speaking, have their informed business decisions second-guessed under the law even if those decisions turn out to have been wrong. But courts will not tolerate Directors, or entire Boards, who are not sufficiently informed about the activities of their organization. Very simply, bad decisions are more easily defended than uninformed decisions.

For this reason, the Director’s duty of care is often referred to as the duty to be informed. For most associations, the staff will ensure that the Board receives sufficient information about the association and its activities, operations, finances, etc. But if a Director needs additional information, the Director should ask that it be provided.

7. Take Corrective Action When Necessary

There is no law or rule mandating how active or farsighted or entrepreneurial an association Board must be, or not be. There is a broad spectrum of acceptable board cultures in this regard – from conservative and staid to aggressive and risk-taking. But it is clear that when a Board has information regarding a serious threat to the association – e.g., regarding the association's tax-exempt status, or financial solvency, or investments – the Board must take corrective action. Being informed is important, but at some point it may also be necessary to act on that information.

8. Invest the Association's Money Prudently

An association Board is by no means a guarantor of positive investment results. However, investment of the association's money should be consistent with a prudent plan. If assets are of a sufficient level, that plan ideally should come from a qualified outside advisor. A Board must also monitor investment results and if those results are consistently negative, the Board should take some remedial action to try to correct the situation.

9. Rely on Advisors

Most state nonprofit statutes provide that a Director may rely on reports and other information provided by certain persons, such as staff, legal counsel, and accountants, as well as other volunteers,

such as Officers and committees. This means that a Director may assume (absent some obvious deficiency) that the information provided is correct and may rely on it in making decisions. If the information turns out to be flawed, and the Director thereby makes an imprudent decision, there should be no fault or liability.

10. Safeguard Assets

This implicates three considerations, primarily. First, the tax-exempt status of an association is a valuable asset that should be protected. This means that the Board should not knowingly allow activities to be undertaken that would endanger that status. The second consideration is insurance. A Board cannot be faulted if some unfortunate circumstance (e.g., theft, personal injury, event cancellation) occurs, but a finger may be pointed at the Board if it did not at least direct that an assessment be made of its insurance needs. Finally, intellectual property – trademark and copyright – is another area that a Board should direct that sufficient steps be taken.

11. Avoid Conflicts of Interest

A Director should not use his or her position or the association's assets in a way that would result in pecuniary or monetary gain for the Director or the Director's business associates, employer, friends, or family. A Director should be sensitive to such concerns and even the appearance of a conflict and be proactive in disclosing both actual and potential and

recusing him/herself from deliberations and voting on the matter at issue.

A well-governed association will have a written conflict of interest policy that includes annual disclosures by Directors.

12. Maintain Confidentiality

Directors have a specific duty to protect and maintain the confidentiality of proprietary and sensitive association information. This is particularly important when disclosure could jeopardize the association in terms of competitive or other disadvantage. This applies as well to manipulation of the outcome of a board action by selective leaks, such as to the membership or media.

II. HOW TO AVOID BEING SUED

A. Introduction

Statistically, the risk of an association Director being named in a lawsuit is, fortunately, not great. But Directors should bear in mind the remark of one legal commentator that “even if the risk of liability were no greater than that of being struck by a lightning bolt, one must observe that prudent men and women do not wander needlessly in a thunderstorm; some are in fact terrified by lightning.”

B. The Most Common Reasons Association Directors Are Sued

One answer to the question of how to avoid being sued as an association Director is act consistent with 12 items in Section I, above. But another key component in avoiding being sued is to know why association Directors typically are sued. Here are the most common reasons:

1. Neglect

Association Boards that fail to keep themselves informed of the status and well being of the association while the association drifts into financial distress or suffers other significant harm, or are informed but fail to take sufficient remedial action, are at risk of being held legally responsible for these failures.

2. Bad Business Decisions

The kinds of situations under this category that can result in litigation generally fall into two categories. One is poor decision making resulting in consistent and significant losses over a period of time. An association Board that essentially sits idly while its reserve dwindles into nothing over several years might be an example. The second circumstance is a single transaction resulting in significant losses or harm to the association. Sale of an asset for inadequate consideration is an example. Failure to secure adequate insurance for the association's most important assets could be another. An ill-fated merger that jeopardizes

the association could also give rise to a lawsuit under extreme circumstances.

3. Violation of the Association's Articles of Incorporation or Bylaws

The authority of an association Board, while broad, is limited by proscriptions contained in the Articles of Incorporation and Bylaws. A knowing violation by the Board, particularly in a manner that harms members or deprives members of key rights, can be the basis for a lawsuit against those Directors who approved such action.

4. Breaking of the Law

A director who, in connection with his or her duties as a director, violates the law, typically thereby violates his or her fiduciary obligations to the association as well.

This applies in particular to violation of the antitrust laws, and such directors may be sued personally, either by an injured party or by the federal government. Courts have held association Directors and other volunteers personally liable for antitrust violations in a variety of contests, including:

(a) using the standards process to harm competitors;
(b) advocating adherence to an association code of ethics that restrains trade;

(c) seeking to unjustly exclude or expel competitors from membership in the association; and

(d) engaging in price-fixing discussions at association meetings.

5. Insider Transactions

Courts will scrutinize any transaction in which it appears that a Director gained some advantage by virtue of the Director's "insider" status. In fact, there is a legal presumption against the validity of a business transaction between a Director and the association, and the burden is on both to prove that the transaction is fair and reasonable to the association.

Unlawful insider dealings can entail sale of association property to a Director at a reduced price; sale of a Director's property to the association unnecessarily or for an inflated price, or both; and engaging the services of a Director by the association either for an excessively high fee or for services that are not needed.

It is important to note that insider transactions are not unlawful per se, but associations and Directors must proceed with caution and ensure that such arrangements benefit the association and are defensible.

6. Lack of Fair Dealing With Members

Courts are receptive to claims by members that Directors have violated their fiduciary duties by not treating members in a fair and transparent manner. In

one case, for example, Directors were found to have acted contrary to their fiduciary duties when they submitted a proposed bylaw amendment to the members for a vote but concealed (or failed to reveal) the adverse impact that this amendment would have had on the rights of the members.

7. Defamation

A claim for libel (written defamation) or slander (spoken defamation) can arise in a number of contexts.

First, it may arise in connection with the discharge of an association employee by the Board of Directors. When a Board decides to terminate an employee, often unflattering remarks are made regarding his or her performance, or even character, and these can form the basis of a defamation action.

Second, when an association expels or disciplines a member, the discussion leading up to such action may include derogatory remarks which can result in a defamation lawsuit by the subject individual or company.

Third, simply by the nature of the authority and exalted position of an association Director within the industry or profession that the association serves, negative comments by an association Board member about an industry participant (including suppliers) may be considered especially harmful, again giving rise to legal action.

This is not to suggest that Directors should be cowed into silence on matters relevant to the association. But they should avoid severe criticism that is unfounded or based on rumor; should limit derogatory comments to matters of direct relevance to the business of the association; and should avoid unnecessary dissemination or publication of such comments.

8. Wrongful Discharge

When an association terminates an employee, typically any legal claim by the employee is brought against the association only and not against an association official individually, and certainly not against Board members. However, Directors may be sued individually if they participate in the termination. This is true when the Board of Directors itself formally terminates an employee, but may also occur when the Board directs the association CEO to terminate an employee, or formally approves the termination of an association employee.

9. Negligent Investment of Association Funds

As stated above, association Directors are not liable for poor investment performance, but they are expected to monitor the association's investments and make adjustments if necessary. Neglecting to exercise this low level of oversight could lead to liability. Relying on investment advice from non-investment professionals, including fellow Board members, also is unwise. And of course investing excessive amounts in

high risk vehicles may result in liability for Directors if those investments fail.

In the two leading cases in this area in the nonprofit context in which Directors were held personally liable, the conduct of the Directors was egregious and amounted to dereliction of duty. In one case, the Directors' negligence resulted in the nonprofit maintaining funds in several non-interest bearing accounts of local banks, the balances of which exceeded $1 million.

In the second case, a petty dispute between two factions on the Board likewise resulted in the organization's funds wallowing in a non- interest bearing account for several years. The Directors were found personally liable for the amount of interest that such funds should have been earning over that time period.

10. Failure to Protect Association Property

As described previously, an association Director has an obligation to seek to ensure that key association assets are protected. In one case, Board members were sued when an employee embezzled a large amount of funds, and the Board had not previously secured theft insurance, despite being advised to do so by a risk management consultant.

11. Usurping A Corporate Opportunity

For a Director to use his or her insider position to avail the Director of a business opportunity in which the association might have an interest can result in personal liability to the Director.

In one illustrative case, several Directors were involved in negotiations on behalf of the association to purchase a for-profit company. These Directors decided, on their own, that the association could not afford to make the purchase, and subsequently bought the company themselves. The court found that this was a business opportunity of the association that the Directors misappropriated.

12. <u>Breach of Contract</u>

As a general rule, a Director is not personally liable for the breach of a contract by the association, even if the Director voted in favor of such breach or termination. However, this is not an absolute rule, and if Directors cause the association to break a contract in order to gain some advantage personal to the Directors, or act with some other improper motive, such as "malice", then there may be a cause of action against the Directors personally.

III. SOURCES OF PROTECTION

In addition to acting in a responsible manner as outlined in Section I and avoiding the circumstances in Section II, there are other sources of protection for association Directors:

A. <u>Volunteer Protection Statutes</u>

Almost every state has enacted some kind of liability protection for volunteer officers and Directors of nonprofits. Many simply serve to raise burden for plaintiffs to something such as gross negligence, rather than simple negligence. A very few provide greater protection; some provide less.

The state statutes also differ in what persons are protected. For example, some statutes apply only to volunteers of Section 501(c)(3) nonprofits, while others apply as well to Section 501(c)(6) trade associations. A number protect the association itself, while many are limited to the individuals only.

One of the most significant questions regarding the effectiveness of these statutes is their interstate applicability. That is, if a lawsuit is filed against Directors of an association in a state other than the state of incorporation or residence of the association, which law will the court apply, the law where the alleged injury occurred, or the law of the state in which the association is incorporated or headquartered? There is no definitive answer. As a result, even if an association is in a state with a favorable statute, that statute might not be applied outside of the state.

Nevertheless, despite some weaknesses in state volunteer protection statutes, they can and do provide meaningful protection to association and other nonprofit volunteers, and are upheld by the courts as valid on a fairly regular basis.

There is also a federal volunteer protection law, which effectively raises the burden of proof needed to hold Directors personally liable. While the applicability to Section 501(c)(6) associations is unclear, this statute is important.

B. Indemnification

All states have enacted laws that allow, and in certain instances require, associations to indemnify their Directors.

While these laws can vary, typically if a Director is named in a lawsuit by virtue of his or her status as a Director, and the individual acted in good faith and in the best interests of the association, then the association is permitted to indemnify that Director against all financial liability, including amounts paid in settlement. This permissive indemnification may be made an obligation of the association by a provision to that effect in the association bylaws.

Most state statutes also mandate indemnification of a Director if the Director is wholly successful in defense of a legal claim.

Something that can be very valuable to Directors is payment of legal fees in advance, and, again, most states allow for this. However, if a Director is ultimately found liable and to have acted in bad faith, the advanced amounts may have to be refunded.

Of course, indemnification is beneficial only if the association can afford the fund it. For this reason, and because of the high cost of litigation, most prudent associations purchase insurance to cover indemnification obligations.

C. Directors and Officers Liability Insurance

Associations are permitted to, and should, purchase insurance to cover liability of their Directors and officers. The usefulness of these policies can differ greatly, and therefore association legal counsel should be consulted to ensure that adequate protection is in place.

Important coverages include defamation, employment (including wrongful discharge), copyright and other types of infringement, breach of fiduciary duty, and antitrust (if available).

Other provisions to closely scrutinize are the ability of the association to select its own counsel, and the payment by the insurance company of costs, including attorneys' fees, or an ongoing basis, rather than only when the matter is resolved, since litigation can last for years.