MOSHER & WAGENMAKER, LLC
Attorneys at Law

Not-for-Profit Directors' and Officers' Responsibilities

Prepared
by
Mosher & Wagenmaker, LLC
33 N. LaSalle St., Ste. 3400
Chicago, IL 60602
312-220-0019
www.mosherlaw.com

© Mosher & Wagenmaker, LLC

I. **Introduction** . . . . . Page 1

II. **Fiduciary Responsibilities of Directors and Officers** . . . . . Page 1
- A. **General Principles and Accountability** . . . . . Page 1
- B. **Common Law and Statutory Fiduciary Duties** . . . . . Page 2
- C. **Duty of Care** . . . . . Page 3
  - 1. **Active Oversight Through Board Participation** . Page 3
  - 2. **Reliance on Outside Counsel** . . . . . Page 4
  - 3. **The Sarbanes-Oxley Act: Document Retention and Whistleblower Policies** . . . . . Page 4
  - 4. **Responsible Fiscal Management** . . . . . Page 5
  - 5. **Management of Corporate Financial Assets** . . . . Page 5
  - 6. **Loans to Corporate Directors or Officers** . . . . . Page 7
  - 7. **Contracts** . . . . . Page 7
  - 8. **Maintenance of Corporate Property** . . . . . Page 7
  - 9. **Supervision of Charitable Services** . . . . . Page 8
  - 10. **Employment Practices** . . . . . Page 9
  - 11. **Duty to Withhold, Collect and Remit Income Taxes, Unemployment Insurance Contributions, and Sales Taxes** . . . . . Page 9
  - 12. **Publications and Other Statements: Avoiding Defamation Liability** . . . . . Page 10
  - 13. **Environmental Hazards** . . . . . Page 10
  - 14. **Distribution of Corporate Assets Upon Dissolution** . . . . . Page 11
  - 15. **Management of Private Foundations** . . . . . Page 11
- D. **Duty of Loyalty** . . . . . Page 12
  - 1. **Transactions Involving Conflict of Interest** . . . . Page 12
  - 2. **Misuse of Corporation Information or Opportunities** . . . . . Page 13
  - 3. **Misappropriation of Corporate Assets or Resources: Inurement and Excess Benefit Transactions** . . . . . Page 14
- E. **Duty of Obedience** . . . . . Page 15
  - 1. **Staying True to the Mission** . . . . . Page 15
  - 2. **Ultra Vires Acts** . . . . . Page 16
  - 3. **Charitable Solicitation** . . . . . Page 16
- F. **Founder's Syndrome** . . . . . Page 17

III. **LEGAL PROTECTIONS FOR DIRECTORS AND OFFICERS; LIMITED LIABILITY, INDEMNIFICATION, AND INSURANCE** . . . . . Page 18
- A. **Illinois Volunteer Director Liability Act** . . . . . Page 18
- B. **Federal Volunteer Protection Act of 1997** . . . . . Page 20

C. Indemnification . . . . Page 20

IV. Conclusion . . . . Page 21

APPENDIX A . . . . Page 22

APPENDIX B . . . . Page 25

Not-For-Profit Directors and Officers' Responsibilities

I. Introduction

State and federal laws affecting directors and officers of not-for-profit organizations have changed dramatically over the last several decades. Gone is the legal principle of "charitable immunity," the traditional grant of absolute protection for those involved in benevolent activities. Gone too is the popular but misguided notion that volunteers performing charitable works have a lower standard of liability in the exercise of their governance responsibilities. Today, directors and officers of not-for-profit organizations are generally held to the same legal standards of conduct as directors and officers of business corporations.

Directors and officers are responsible for overseeing programs, finances, employees, and the vision of the not-for-profit organizations they serve. Typically, they are volunteers. Often, they are recruited to contribute their time, talents, and treasures to worthwhile causes through involvement in meetings, fundraiser events, and special committee work. Ideally, directors and officers receive some orientation to their board leadership, learning valuable information about the organization's corporate structure, its operations, and expectations for their service. Regrettably, however, many directors and officers serve with little understanding of their legal duties that, if breached, can result in both great harm to organizations and personal liability.

This article describes the important fiduciary responsibilities of directors and officers under Illinois and federal law for governing not-for-profit organizations. In addition, it explains the available legal protections and precautions of which directors and officers should be aware. Last, several recommendations are made throughout the article for serving the best interests of not-for-profit organizations through effective board leadership.

II. Fiduciary Responsibilities of Directors and Officers

A. General Principles and Accountability

Under well-established legal principles, leaders of not-for-profit organizations serve as stewards of organizations' assets and other interests. Because charitable assets are by definition intended for public benefit, they belong to no private person and thus must be guarded carefully for the public's interest. Under the Illinois General Not-for-Profit Corporation Act of 1986, leaders with such responsibilities are identified generically as directors. See 805 ICLS 105/ 108.5(a). Other leadership labels may be used if preferred, such as trustee or elder. Officers also have specified responsibilities for governing not-for-profit organizations, and their titles may vary similarly. See 805 ILCS 105/108.50. Whatever title is used, directors and officers owe certain fiduciary duties to not-for-profit organizations they serve. The term "fiduciary" simply means that these individuals are entrusted with accountability for the organization's well-being.

© Mosher & Wagenmaker, LLC

Directors and officers are legally accountable to the organization, its members (if any), other directors and officers, the state attorney general's office, the Internal Revenue Service, and other government agencies. Breaches of their fiduciary duties may result in personal liability. Thus, wise directors and officers take their duties seriously and strive at all times to act responsibly in the organization's best interests.

Three sources of enforcement exist against not-for-profit directors and officers who have breached their legal duties to the organization. The first lies with corporate members, officers and directors. These individuals may bring suit against errant directors. See, e.g., 805 ILCS 105/103.15, 105/108.65(a)(1), 105/112.50(b). Second, the Illinois Attorney General's office has a wide range of legal powers to hold directors and officers accountable for improper governance and management. See, e.g., 760 ILCS 55/16, 55/16.5, 55/17; 225 ILCS 460/16, 460/16.5, 460/17, 460/19; see also 805 ILCS 112.50(a) (judicial dissolution upon Attorney General action). While these powers are seldom exercised, they provide recourse in the name of the people of the State of Illinois where not-for-profit leadership fails in its duties to govern responsibly. The third source of enforcement lies in the taxing authority of the federal, state and local governments. Laws pertaining to excessive compensation, self dealing, employer tax withholding and retail sales taxes impose personal liability on corporate directors, sometimes with onerous results. Taxing authorities also can pursue the personal assets of errant directors with taxes, penalties and interest. Although there are countless ways in which directors and officers can incur personal liability, it can be avoided with careful adherence to fiduciary duties owed in each situation.

B. Common Law and Statutory Fiduciary Duties

As developed by Illinois courts, directors and officers' fiduciary duties fit within three categories. The first is the duty of care, otherwise described as the duty to exercise "due diligence" and to give "informed and prudent attention" to not-for-profit affairs. The second is the duty of loyalty, which requires honesty, good faith, fairness and avoidance of conflicts of interest. The third is the duty of obedience to the corporate purpose and the official policies of the board of directors. The Illinois Charitable Trust Act expands these duties into eight enumerated areas:

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;
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;
8. To comply and to cause the charitable organization to comply with this Act.

760 ILCS 55/15(a). In addition, numerous federal laws governing tax-exempt charitable organizations affect directors and officers' fiduciary duties, as explained throughout the remainder

of this article. The following sections will explain these duties in more detail.[1]

C. Duty of Care

The duty of care requires directors and officers to exercise reasonable diligence and due care in conducting the not-for-profit's affairs. For example, they must stay informed about the activities and finances of the organization by regularly attending corporate meetings, actively examining and evaluating the records made available to them by staff, and understanding how the organization functions under its bylaws. Board members must act in good faith as they make decisions and seek always to avoid the misuse or waste of its assets. When a decision involves complex matters, the board should engage subject matter experts, community representatives, and professional advisors if the directors lack the requisite skills to make an informed decision. Good intentions are not an adequate defense against liability concerning a complicated transaction if directors lack sufficient expertise and fail to obtain appropriate outside input.

The duty of care under Illinois law is evaluated according to the "business judgment rule," under which directors and officers are presumed to make decisions on an informed basis and in good faith. *Ferris Elevator Co. v. Neffco, Inc.*, 285 Ill. App 3d 350, 674 N.E.2d 448 (3d Dist. 1996). This presumption may be overcome upon a showing of gross negligence or willful misconduct, with resulting personal liability. Id. Accordingly, to stay within the business judgment rule's protection, directors and officers must take the same care that an ordinary and prudent person would exercise under similar circumstances. Numerous fact-specific situations may implicate the duty of care, and hundreds of judicial decisions have been rendered interpreting this duty. The following paragraphs describe the most common ways that directors and officers should fulfill this duty.

1. Active Oversight Through Board Participation

Responsible directors and officers exercise active oversight through participation in board and committees meetings, preparation for them, and follow-up work. In order to be sufficiently knowledgeable about the fiscal and functional workings of the organization and its staff, directors and officers must stay informed. The law will not excuse a director's culpability based merely on his or her absence from board meetings. The duty of care holds each director and officer responsible for the not-for-profit organization's decisions and activities, regardless of whether he or she was present or absent at any particular meeting.

To adequately reflect the board members' decisions and actions, minutes of each board and committee meeting should be recorded in writing and maintained in a central, safe

---

[1] For a very succinct statement of these principles, see the Donors Forum's "Illinois Nonprofit Principles and Best Practices" available at www.donorsforum.org.

© Mosher & Wagenmaker, LLC

location. The written minutes should clearly express the board's or committee's intentions. Ideally, minutes should be sent to all directors and officers shortly after each meeting so that they can review the minutes while their memory is fresh. All minutes (for board and committees) must be reviewed at the next meeting of the board and expressly approved.

For significant board action, written resolutions should be prepared, signed by the corporate secretary, and maintained with the corporation's minutes. Assistance of legal counsel may be appropriate to ensure that the resolution is legally sufficient to accomplish the board's intentions. Depending on the type of resolutions, the board may need to follow up with staff or others to assure proper implementation.

Directors and officers should also be familiar with their organization's bylaws, other corporate documents, official policies, and reporting obligations. Well drafted bylaws should contain numerous vital provisions for effective organizational operation, including board members' election and duties, quorum requirements for valid meetings, voting requirements for effective decisions, indemnification, officers' responsibilities, financial policies, and committee structure. In addition, a well-established not-for-profit should have several important board-approved policies, some of which are discussed below, such as conflict of interest, investment, gift acceptance, document retention, whistleblower reporting, political activity, accountable reimbursement of expenses, confidentiality, technology use, and anti-harassment policies. The board also should be knowledgeable about the organization's reporting responsibilities including payroll tax liability, other employment-related obligations, and its annual IRS Form 990 information return obligation (which varies depending on the organization's revenues and assets).

2. Reliance on Outside Counsel

Directors and officers never may completely relinquish their duty of care. Often, however, they may delegate limited responsibility to committees or persons to investigate a matter, carry out a project, or advise them on an important question. For example, board members rely daily on executive directors to manage staff and financial matters, they periodically hire attorneys and accountants for their specialized areas of expertise, and they may appoint a special committee to develop plans such as for a fundraising event. In these situations, directors and officers should undertake appropriate due diligence to make sure that the persons or groups are competent in their respective areas and can be expected to act responsibly. If some objective reason exists to suspect their competence or reliability, then the directors should make additional inquiries to satisfy themselves as to the validity of the information furnished. So long as the directors and officers use reasonable care in delegating to others and rely on them in good faith, the directors will fulfill their legal duty of care.

3. The Sarbanes-Oxley Act: Document Retention and Whistleblower Policies

The great outcry that arose from the collapse of Enron, WorldCom, and other publicly-held corporations caused a stir in Congress and resulted in the enactment of federal legislation known as the Sarbanes-Oxley Act of 2002. This comprehensive law (commonly referred to as "SOX") is directed at improving financial accountability of large, publicly-traded corporations. Two provisions apply to not-for-profit organizations.

First, under section 802 of the Act, it is a crime to knowingly alter, destroy, conceal, or falsify any record or document with intent to impede, obstruct, or influence a federal investigation or the administration of any other federal matter. Penalties include fines and up to 20 years' imprisonment. Based on the serious consequences under SOX, it is recommended that not-for-profit organizations adopt and follow a document retention policy to promote compliance with applicable legal requirements and otherwise for good corporate practice.

Second, persons who report financial misconduct by an organization, its leaders, or its employees enjoy legal protection under SOX, if such information relates to the commission of a federal offense and is reported to a law enforcement official. Retaliation against such whistleblowers may result in fines of up to $10,000 and imprisonment of up to 10 years. 18 U.S.C. § 1513(e). The scope of this provision is disturbingly broad, covering "any action harmful to any person" that is done "knowing[ly], with the intent to retaliate." Accordingly, it is similarly recommended that not-for-profit organizations adopt and follow whistleblower policies that clearly set forth procedures for reporting allegations of wrongdoing.

4. Responsible Fiscal Management

Internal financial controls prevent loss from employee error, mismanagement and fraud. Good internal controls include specific directives such as how money is deposited and disbursed, accounting for petty cash, and authorization for check-writing and expenditures limits, In essence, these functions should be segregated between custody (of assets), recording (transactions affecting assets), and decision-making authority (over the use of assets). When properly instituted, these controls should prevent loss by developing systems that will uncover employee error, mismanagement and fraud at an early stage. To the extent that they are effective, they should lessen any temptation for intentional diversion of funds.

An annual audit by an independent auditor is an excellent method of testing the effectiveness of an organization's internal controls. The board should be in charge of the audit engagement, meet with the auditor at its conclusion, and oversee the completion of all corrective tasks identified in the auditor's management letter.

5. Management of Corporate Financial Assets

In the landmark case of *Stern v. Lucy Webb Hayes National Training School*, 381 F. Supp. 1003 (D.C.D.C. 1974), the court ruled that the directors had breached their fiduciary duties

© Mosher & Wagenmaker, LLC

in allowing hospital assets to be grossly mismanaged and therefore held them responsible for repaying lost charitable funds. In that case, some directors had willfully and perhaps intentionally mismanaged certain funds for personal gain. Others simply failed to exercise the requisite care to supervise investments and expenditures, but they were also held liable for the mismanagement. Notably, the directors' laxness in allowing large sums of money to be held in checking accounts, rather than being invested, amounted to a breach of their duty of care. A key factor was the directors' overall abdication of oversight responsibility to a few directors, who managed the charitable assets under clear conflicts of interest.

Under Illinois law, directors and officers similarly owe a legal duty to responsibly manage their not-for-profit organizations' charitable assets. See 760 ILCS 55/15(a). This means that they may not allow waste of charitable assets, improper conflicts of interest, or other misuse of charitable funds. Id. If the organization holds more than $4,000 in charitable assets, they also are responsible for registering with the Illinois Attorney General's office and reporting on the funds' management and use. 760 ILCS 55/2, 55/5, 55/7. For many organizations, particularly those with an endowment or other reserve funds, they should have a board-approved written investment policy that provides guidelines for investment of the organization's charitable assets.

Trustees of charitable trusts operate under a more stringent standard known as the "prudent investor" rule. Specifically, under the Illinois Trusts and Trustees Act, each trustee has the "duty to invest and manage the trust assets as a prudent investor would considering the purposes, terms, distribution requirements, and other circumstances of the trust." 760 ILCS 5/5(a)(1). This standard requires "reasonable care, skill, and caution." Id. Accordingly, it is often appropriate to consult with outside professional advisors who are knowledgeable and competent in financial investment matters. No specific investment – taken alone – is to be viewed as prudent or imprudent. Rather, the investment decisions are to be judged in terms of the anticipated effect on the trust portfolio as a whole under the currently available facts and circumstances. 760 ILCS 5/5(a)(2). Notably, "[t]he prudent investor rule is a test of conduct and not of resulting performance." Id. Additional responsibilities include the duties to diversify the trust's investments, to review retention of assets, to consider dispositions of assets, and to pursue an impartial investment strategy that includes consideration of income production and safety of capital, tax consequences, general economic conditions, and related investment costs. 760 ILCS 5/5(a)(4), (5), (6).

The Illinois Trusts and Trustees Act does not permit trustees to delegate any responsibilities involving "the exercise of judgment and discretion." 760 ILCS 5/5.1(a). A very important exception to this rule exists, however, for "acts constituting investment functions that a prudent investor of comparable skills might delegate under the circumstances." Id. The Trusts and Trustees Act specifically permits trustees to delegate investment functions, so long as the certain

requirements are satisfied such as the exercise of care, skill and caution in selecting and overseeing an investment agent. 760 ILCS 5/5.1(b)(1), (2), & (4).

To better fulfill their duty of care, directors and officers of not-for-profit organizations may apply these trust principles to their management of charitable resources. They

should exercise great care in managing their organizations' charitable assets, delegating responsibility as appropriate but with continued oversight. A written investment policy that is prepared with advice of legal and financial counsel may also be appropriate.

6. Loans to Corporate Directors or Officers

Generally, directors and officers have no authority to approve loans of corporate funds to themselves. Such transactions create a perception of self-dealing and, unless they conform in every respect to commercial terms, violate the duty to care for the management of not-for-profit funds. Such loans may also create a conflict of interest, i.e., a violation of the duty of loyalty as described below. The Illinois Not-for-Profit Corporation Act permits such loans only under very special circumstances. Notably, it also provides that every person participating in the making of such a loan remains *jointly and severally liable* to the not-for-profit corporation for its unpaid balance until it is repaid. See 805 ILCS 105/108.80. Under federal law, private foundations are absolutely prohibited from making such loans. I.R.C. § 4942 (self-dealing).

7. Contracts

As a matter of corporate law, those persons who act with actual or apparent authority may bind the not-for-profit corporation to perform contractual obligations. Accordingly, directors and officers should be careful in monitoring its representatives, communicating to them clearly their scope of authority and circumscribing their authority when necessary. In addition, the corporation's bylaws should contain financial policies that require board approval for certain transactions (such as loans) and for expenditures over certain limits. The bylaws also require dual signatures for checks or other transactions. Ideally, a high level of trust should exist between the board, its executive director, and other key positions.

When signing any contract or other agreement on behalf of a not-for-profit organization, directors and officers should be careful to identify in writing that they are signing in their board capacity and not individually. (E.g., "Save the World, By John Smith, President.") In this way, the board member will bind the organization but not themselves personally.

From time to time, board members may also be asked to individually sign contracts, such as to personally guarantee a loan. This may help the not-for-profit organization not only to qualify for the loan but also to assure the lender that the organization's leaders will take the financial obligation very seriously. Before doing so, responsible directors and officers should carefully consider this commitment and consult legal counsel as to their rights and responsibilities under such arrangements. If the not-for-profit defaults on the contract, not only for nonpayment of monies due but for many other potential reasons over which the director may have no control, the director may be held personally liable.

8. Maintenance of Corporate Property

When a not-for-profit corporation owns or controls real estate, automobiles or other property that could be involved in causing personal injuries, the directors should take care that such property is properly maintained in order to protect others from harm. In addition, directors should make sure that adequate insurance is in place covering the proper corporate entity, in sufficient amounts, and with appropriate types of coverage. These matters are particularly important if the organization invites the public into its facilities.

If directors are volunteers, they are not subject to personal liability for negligence related to the organization's property such as from equipment malfunction or slip and fall accidents. 805 ILCS 105/108/70(a). Liability may be imposed for negligence resulting in harm, however, if directors are paid compensation for their board service. Id.; see also 805 ILCS 105/108/70(b) (directors of certain organizations may receive compensation of up to $5,000). In cases of gross negligence or willful or wanton misconduct, all directors and officers – whether volunteer or paid – may be held fully and personally liable for damages to others. 805 ILCS 105/108.70(a).

9. Supervision of Charitable Services

When a not-for-profit organization provides services to the public, its directors and officers must similarly take care that its workers are reasonably competent to provide the services and that services themselves are appropriately managed. Screening for workers, employees, and volunteers is recommended. Depending on the services and responsibilities, appropriate screening may include criminal background checks, reference checks, credit checks, personal interviews, and follow-up investigations for questionable information. Criminal background checks are so easily done and inexpensive that failure to do them may amount legally to gross negligence, and therefore potential personal liability of directors and officers, in cases involving vulnerable persons such as children. See, e.g. *Carter v. Skokie Valley Detective Agency, Ltd.*, 256 Ill. App.3d 77, 628 N.E.2d 602, 604 (1st Dist. 1993) (employer held liable for sexual assault committed by a security guard hired without a detailed background check). Further information may be obtained from local law enforcement officials or other sources to determine the appropriate scope of such background checks. In some circumstances, such as involving very long-term employees, subsequent background checks may be advisable as well.

In addition, directors and officers should make sure that the organization's employees are appropriately supervised in the performance of their work. If not, the organization could be held liable to others under legal theories of negligent hiring or supervision of employees. Id.; *Van Horne v. Muller*, 185 Ill.2d 299, 705 N.E.2d 898, 904-05 (1998); *Johnson v. Mers*, 279 Ill. App.3d 372, 664 N.E.2d 668, 672 (2d Dist. 1996) (negligent hiring cause of action where employer knew or should have known that employee had particular unfitness for position so as to create danger of harm to third persons, and unfitness was known or should have been known at time of hiring). Volunteer directors could also be held personally liable in instances of gross negligence, such as harm resulting from a known convicted sex offender being employed to work with children. The organization, and its volunteer directors if determined to be grossly negligent, could likewise be held liable under the legal theory of negligent retention of employees if the organization becomes aware of facts

indicating that it is no longer safe for an employee to continue his or her duties and that person subsequently harms another person. E.g., Strickland v. Communications & Cable of Chicago, Inc., 304 Ill. App.3d 679, 710 N.E.2d 55, 58 (1st Dist. 1999).

All of these precautions thus should be part of an effective and helpful risk management plan to protect a not-for-profit organization, its workers, and others with whom it comes in contact.

10. Employment Practices

Employees are typically among a not-for-profit organization's best assets, and yet the enormous potential liability associated with them is akin to carrying a loaded gun. Not only can their harm to others cause liability to a not-for-profit (and even personal liability to its leaders in cases of gross negligence), they are protected by a myriad of complex and varied employment laws that provide for private rights of action, government intervention, and even punitive damages and criminal penalties under certain laws. See, e.g., 42 U.S.C. § 2000e, *et seq.* (Title VII of the Civil Rights Act); 42 U.S.C. § 12101 *et seq.* (Americans with Disability Act); 29 U.S.C. § 216 (Age Discrimination in Employment Act); 29 U.S.C. § 666 (fines and criminal liability for violations of Occupational Health and Safety Act); 29 U.S.C. § 201 *et seq.* (fines and criminal liability under the Fair Labor Standards Act).

In short, disgruntled or injured employees who assert employment-related claims – even if specious – can cause great expense, distraction from an organization's mission, personal liability, and damage to an organization's or individuals' reputation. Accordingly, directors and officers should carefully oversee employee matters through adopting sound personnel policies, following them consistently, hiring high-quality supervisors (including a human resources manager for larger organizations), treating employment problems as confidential, and seeking legal counsel as appropriate such as in cases of employee terminations or grievances. While as a matter of board governance directors should not directly supervise an organization's employees, they nevertheless should hold the executive director and other key leaders accountable for complying with employment laws and treating employees fairly. If sound employment practices are followed with the board's wise leadership, then potential liability should be minimized and the workplace environment can be more productive and positive.

11. Duty to Withhold, Collect and Remit Income Taxes, Unemployment Insurance Contributions, and Sales Taxes

Federal and state tax laws impose upon corporate officers and directors the responsibility to withhold income taxes from employee wages and remit them to the government. Under Internal Revenue Code sections 6321 and 6672, the managers who make decisions concerning corporate expenditures may be personally liable to pay employment taxes out of their own pockets if the corporation is unable to do so. Specifically, section 6672(a) imposes a 100% penalty, in addition to any other nonpayment penalties for "[a]ny person required to collect, truthfully account

for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof." Under Code section 6672(e), liability may be imposed on volunteer board members who have actual knowledge of organization's failure to pay taxes or participate in organization's financial operations. Similarly, Illinois board members may be held personally liable for failure to collect and remit state unemployment insurance contributions and state sales taxes. These responsibilities should thus be taken very seriously by the board of directors.

Directors and officers with signatory authority may be particularly at risk, based on their presumably increased awareness of the organization's financial affairs. Especially when financial resources become tight, directors *must* ensure that the government is sent all withheld employee taxes. There should be no exceptions to this policy. No immunity statutes protect directors and officers from this liability, regardless of how innocent they may appear to be.

12. Publications and Other Statements: Avoiding Defamation Liability

Directors and officers should take care that writers and editors of all organizational publications exercise responsibility for their written content. The potential for publishing slanderous or libelous statements increases when a not-for-profit is involved in controversial issues. Highly motivated advocates sometimes fail to exercise good judgment when writing about adversaries. Those people identified publicly as "slumlords," "loan sharks," "waste dumpers" and "predators" are the very people who are most likely to sue for libel or slander.

Directors, officers, and staff should be careful in speaking about their organization, its friends, and its enemies. So long as they stick to true statements of fact or statements purely of opinion, no liability should result. However, it may be cost-prohibitive to defend against a defamation claim. With respect to sensitive matters, such as a claim of sexual harassment, it is generally prudent to limit disclosures on a "need to know" basis to avoid potential defamation claims as well as to protect the confidentiality privacy of those involved. Not only may the organization be held liable for libel or slander, but directors may be personally liable if they willfully fail to prevent injurious statements or otherwise fail to distance the organization from the statements of its members or staff.

13. Environmental Hazards

Directors and officers should exercise extreme caution in dealing with real estate, particularly property used for industrial purposes and other potentially pollutant activity. Under federal and state law, liability may be imposed on owners of environmentally contaminated property. See, e.g., 42 U.S.C. § 9601 *et seq.* (Comprehensive Environmental Response, Compensation and

Liability Act; "CERCLA"); 415 ILCS 5/1 *et seq.* (Illinois Environmental Protection Act). Legal liability may exist as well under common law theories such as negligence and nuisance.

© Mosher & Wagenmaker, LLC

For example, a donor may seek to transfer ownership of real estate that contains environmental hazards to a not-for-profit organization. If government officials later determine that the hazards are sufficiently dangerous, they may order the toxic substances to be cleaned up. Under CERCLA, regardless of whether the organization's leaders were aware of this problem at the time of donation or purchase, the government may impose penalties and even clean-up costs on the organization. In theory, prior owners share in this liability, but finding them and actually collecting money from them may not be possible. If that is the case, and the government requires clean-up or other remediation, then the current not-for-profit owner will be liable for the entire costs.

For these reasons, many properties may be so tainted that it is never reasonable to acquire them without the financial wherewithal to clean them up. For not-for-profits seeking to focus on their mission and avoid such problems, it may be best to look that gift-horse donor in the mouth and say "no, thank you." At the very least, environmental inspections should be part of the due diligence process for potential real estate acquisitions.

14. Distribution of Corporate Assets Upon Dissolution

The Illinois General Not-For-Profit Corporation Act contains numerous requirements for dissolution of a not-for-profit corporation, which generally are aimed at making sure that charitable assets are handled properly and consistently with charitable legal principles. For example, the Act requires that upon dissolution, all of a not-for-profit's remaining assets must be distributed to other qualified charitable recipients. 805 ILCS 105/112.16(e). Dissolution may occur voluntarily, such as when the directors vote to dissolve the corporation, or involuntarily, such for failure to file required reports with the Secretary of State's office or by court order.

If the Act's dissolution requirements are not followed, directors and officers may be held personally liable. Examples of circumstances where directors and officers may be held personally liable include the following: (1) directors who vote to distribute the not-for-profit's assets prior to its dissolution, if such distribution would unjustly deprive legitimate creditors: (2) directors who fail to properly notify creditors of a corporation before it is dissolved and the assets are distributed; and (3) directors who continue the corporate business after dissolution, with resulting personal liability for debts that arise after the dissolution. 805 ILCS 105/108.65(a). Accordingly, while dissolving a not-for-profit's corporate status may be difficult, it is nevertheless more important than ever that the directors and officers fulfill their duty of care in this final stage.

15. Management of Private Foundations

Organizations treated by the Internal Revenue Service as private foundations are covered by special rules intended to ensure that assets protected from income taxation are used for charitable purposes. Failure to comply with private foundation rules may expose both the foundation and its managers to penalties and excise taxes. Directors and officers of such organizations should have competent legal counsel to assist with compliance. As with withheld payroll taxes, the potential penalties are onerous.

© Mosher & Wagenmaker, LLC

D. Duty of Loyalty

The duty of loyalty prohibits directors and officers from using their position of trust for personal advantage at the expense of the not-for-profit corporation. In negotiating business transactions, directors and officers must ensure that their families, friends, or others who have a significant interest in the organization do not receive special benefits due to their own position of trust. This is not to say that all such contracts are prohibited. However, whenever personal and business relationships co-exist, the highest loyalty must be demonstrated to protect the corporation. The most common transactions that risk a breach of this duty are transactions involving conflict of interest, misuse of the organization's information or opportunities, and misappropriation of the organization's assets.

1. Transactions Involving Conflict of Interest

Generally, a director or officer who may receive a tangible personal benefit as a result of a decision affecting the corporation's business or assets has a conflict of interest. A responsible board should never allow an improper conflict of interest. If properly addressed, however, the board may work through the conflict to achieve a favorable resolution that does not result in any harm to the organization or result in a breach of a director's duty of loyalty.

For example, consider a not-for-profit corporation that needs a new roof for its building, and one of its directors owns a fifty-percent interest in a roofing business. The director's business may be considered for a roofing contract, but the transaction involves an inherent financial conflict of interest. Accordingly, if the director is interested in having his company enter a roofing contract with the not-for-profit (perhaps even at a substantial discount as a way to help the organization), she must first disclose her interest in the business to the other board members, and such disclosure should be reflected in writing. Second, the board should obtain other bids in order to evaluate which bid best serves the organization, both in terms of price as well as other important factors such as quality of work, timeliness, and reliability. Third, the conflicted director may not participate in the board's determination of which roofing business to hire, and her recusal should be reflected in the written minutes. By following these steps, the not-for-profit's best interests should be served without any improper conflict of interest, whether or not the director's business is be hired.

These measures are consistent with the Illinois General Not-for-Profit Corporation Act, under which directors are permitted to engage in transactions that involve conflicts of interest, so long all directors are aware of the situation, the director does not participate in the decision to engage in the transaction, and it is fair to the corporation. 805 ILCS 105/108.60. If these safeguards are not followed, then legal grounds may exist for invalidating the transaction. Id. at 108.60(a).

This area is also particularly important to the Internal Revenue Service, which is continually suspicious of potential conflicts of interest. The IRS' concern is amply reflected in several questions contained in its Form 1023 for Recognition of Tax-Exempt Status and the IRS

© Mosher & Wagenmaker, LLC

Form 990 annual information return. As more fully explained below, if the IRS determines that a director has benefitted from "insider" transactions that involve a breach of loyalty detrimental to the organization, then he or she may be forced to surrender or pay back the benefits improperly gained. Other directors who knowingly permitted the improper transactions may be compelled to compensate the corporation. Substantial penalties may also be assessed against both the conflicted director and the other directors who approve the transaction at issue.

To protect both the organization and its directors, a conflict of interest policy should be adopted that provides specific guidelines to guard the organization from improper conduct. A version of the IRS-approved conflict of interest form is enclosed as Appendix A. A corresponding annual conflict of interest disclosure form is enclosed as Appendix B. All directors, officers, and key employees should complete this form on a yearly basis. These documents provide effective mechanisms for directors to disclose any actual or apparent conflicts and for the board to evaluate them in order to make decisions in the organization's best interests. In the event of any later allegations of improper conflicts of interest, it will be paramount to have such contemporaneous documentation.

2. Misuse of Corporation Information or Opportunities

Directors and officers frequently obtain special information about economic opportunities in the course of their governance activities. The duty of loyalty prohibits them from using confidential or other special information for personal benefit if such use would disadvantage the corporation. Directors who serve on multiple boards with overlapping areas of service may be particularly vulnerable. For example, if they learn of potential grant or program opportunities that could benefit each organization they serve, they should consider not only whether to recuse themselves from the decision-making process on that matter but also whether they should resign from one of the boards.

Another breach of loyalty example is contained in *Mile-o-Mo Fishing Club, Inc. v. Noble*, 62 Ill. App. 2d 50, 210 N.E.2d 12 (1965). In that decision, the Illinois Court of Appeals ruled that an officer breached his duty of loyalty by misusing financial information obtained as a board member. The case involved a former board president who gained knowledge of a real estate transaction while in office, including the proposed financial terms between the club and the potential seller. After he left office and the club did not purchase the property, the former president used this information in negotiating a sale of the targeted property to himself. The club learned of the disloyalty and sued him. The court ruled in the club's favor and, as an appropriate equitable remedy, ordered the former director to transfer the property to the club at the same price they had negotiated before his interference.

3. Misappropriation of Corporate Assets or Resources: Inurement and Excess Benefit Transactions

Blatant theft of not-for-profit assets is uncommon. A more common breach of the

duty of loyalty occurs when directors or officers use their positions of influence to gain unauthorized personal access to corporate resources like cars, telephones, office and production equipment, etc. These activities are often rationalized as a form of casual compensation by a person who works hard as a "volunteer" director. They also may include "perks" given to board members and board-approved compensation packages for employees.

If these benefits are an improper use of charitable resources, then they will constitute prohibited "inurement." Section 501(c)(3) of the Internal Revenue Code, under which many not-for-profits operate, expressly forbids inurement as antithetical to public charity status. At least theoretically, revocation of a tax-exempt organization's status is warranted upon a finding of any inurement.

In addition, and more likely, they will be subject to federal intermediate sanctions under section 4958 of the Internal Revenue Code. This law authorizes "intermediate sanctions" against "disqualified persons," "organization managers," and others who receive or approve of improper private benefits known as "excess benefit transactions" (EBT). An EBT occurs whenever a disqualified person receives a benefit from an exempt organization (as described in section 501(c)(3) and 501(c)(4) of the Code) that exceeds the value of the services or goods provided to that organization. 26 C.F.R. § 53. 4958-1(b). The term "disqualified person" includes anyone who exercises (or can exercise) substantial influence over the organization within five years prior to the transactions at issue, including directors, trustees, officers, key employees, their families, or entities in which any of these persons own more than a thirty-five percent interest. An "organization manager" may include a director or officer.

If an EBT occurs, the disqualified person must pay back the EBT and, in addition, is subject to statutory penalties of up to 225% of the EBT. I.R.C. § 4958 (a)-(b). Paying back the EBT promptly will dramatically reduce the likelihood that penalties will be imposed. Board members who approve payments of funds or other transactions that are EBTs are subject to personal liability for an excise tax of 10% on each EBT, up to a $20,000 maximum penalty. Joint and several liability may be imposed in the case of multiple decision-makers. I.R.C. § 4958(d)(2). Given that EBTs are by their nature improper uses of not-for-profit resources, organizations may not pay any penalties on behalf of disqualified persons or board members. The liability rests solely with the responsible individuals. Moreover, these federal penalties are in addition to any liability imposed under state law for breach of the fiduciary duty of loyalty.

Other potential EBTs include compensation and reimbursement expenses paid to disqualified persons. For example, an executive director's compensation package may amount to an EBT if it exceeds what would be objectively reasonable pay under the circumstances. A rebuttable presumption will arise that the payment is reasonable and thus not an EBT, however, if the following safeguards are used. First, the compensation plan, including all direct and indirect benefits, should be approved by a disinterested and independent board. Second, the board should consider comparable pay data for similarly situated organizations. Third, the decision should be contemporaneously documented in board minutes, written resolution, or as otherwise appropriate.

© Mosher & Wagenmaker, LLC

26 C.F.R. § 53.4958-6. Another example of EBTs are zero or low-interest loans, such as to help a new executive director relocate. Conversely, an unreasonably high interest rate paid to a director for a loan to the not-for-profit organization may similarly be an EBT. Payments by a not-for-profit organization on behalf of board members, such as spousal travel or club memberships, also may constitute EBTs under certain conditions.

Notably, the IRS will treat payments for reimbursable expenses as "automatic" EBTs, if no written accountable reimbursement plan exists and is followed for proper reimbursement of legitimate expenses. See "*Automatic" Excess Benefit Transactions*, IRS 2004 EO CPE Text (Brauer and Henzke). In such cases, repayment of the unaccounted expenses must be made even if the expenses can later be shown to be legitimate. Accordingly, not-for-profit organizations should make sure that a written accountable reimbursement plan is in place that requires documentation to be timely submitted for reimbursement. The organization should also be scrupulous regarding organizational use of credit cards, requiring meticulous record-keeping and substantiation of expenditures. Board members may be reimbursed or otherwise spend organizational resources only for legitimate board purposes, such as reasonable expenses related to board meetings, committee work, or other activities on behalf of the organization.

The IRS has demonstrated great concern about potential EBTs and other abuses of charitable resources. For example, Part IV of the new IRS Form 990 contains questions requiring disclosure of all EBTs. Failure to respond fully may trigger additional late filing penalties for the reporting organization. In addition, under 2008 federal regulations, the IRS has prescribed factors for evaluating when repeated EBTs warrant revocation of the organization's tax-exempt status. See Fed. Register, Vol. 73, No. 61 (Mar. 28, 2008).

In light of the significant penalties and other adverse consequences to which disqualified persons, board members, and organizations may face, EBTs should be avoided through careful board oversight of financial expenditures, proper due diligence and documentation regarding compensation and other payments, and prompt repayment of any resulting EBTs.

E. Duty of Obedience

1. Staying True to the Mission

A third fiduciary duty is the duty of obedience – that is, to adhere to the not-for-profit organization's corporate purposes. In a well-run organization, the directors and officers may serve as "bumper guards," overseeing the staff and making sure that the corporation follows its articulated vision and complies with its legal obligations. To do so, the board members should be well aware of the corporation's purposes as stated in its articles and bylaws, they should ensure that the organization's activities are consistent with these purposes, and they should help shape the

organization's plan in accordance with them. This duty of obedience is closely relevant to the duty of loyalty, focusing on keeping the organization's mission uncompromised by other competing

interests.

Violations of the duty of obedience may thus occur when the board allows the organization to stray from its mission. For example, the board should not allow staff to pursue grants or other program opportunities that are inconsistent with the organization's stated purposes. Likewise, for organizations with geographical limits for their activities, the board should keep funding and other resources directed at the targeted areas.

To the extent that the board and its staff leaders recognize, however, that changing times or circumstances warrant modifying the organization's purposes, such as to better fit current demographic needs and available funding, the board should lead the way in thoughtfully reshaping the organization's mission. Ideally, this should be accomplished through careful strategic planning, rather than by whimsy or fiat. At the conclusion of such deliberative process, the organization's articles and bylaws should be updated to reflect any changes.

2. Ultra Vires Acts

The duty of obedience prohibits directors and officers from unauthorized corporate actions, such as buying or selling property without proper board approval and contracting to receive or provide services that are not properly within the purposes of the corporation. Under corporate legal principles, such unauthorized activities are *ultra vires*, that is, beyond the power they have been granted by virtue of their corporate positions. Historically, *ultra vires* acts were null and void, regardless of whether they cause injury to an innocent third party. The Illinois General Not-For-Profit Corporation Act eliminated this defense, however, making *ultra vires* acts voidable only under certain limited circumstances involving a member or director's action against the corporation. 805 ILCS 105/103.15. Morever, all officers or directors who knowingly exceed their corporate authority may be personally liable for injuries to unsuspecting third parties as well as to the corporation itself. Id. at 105/103.15.

3. Charitable Solicitation

The business of soliciting charitable funding for not-for-profit activities has become increasingly competitive. Not-for-profit boards that improperly solicit funding for programs or services that lie outside of the organization's charitable purposes are in violation of their duty of obedience to those purposes. Beyond diverting essential corporate energies to inappropriate objectives, the officers and directors may expose the corporation to liability arising from the negligent delivery of services that the organization is not equipped to perform.

A variation on this theme is the solicitation of funds for a designated purpose and the subsequent use of those funds for a different purpose. An organization that is highly dependent upon grant funding may find that grantmakers will no longer support activities that have become part of the organization's ongoing services, so they apply for and receive grants for new and innovative services or programs that they do not intend to operate. The grant funds are diverted to other uses

and the donor is misled about the diversion. Such a scheme not only violates the contractual relationship with the grantmaker, it violates underlying charitable trust principles.

F. Founder's Syndrome

An important issue that impacts directors and officers' fiduciary duties of care, loyalty, and obedience is the phenomenon commonly known as "founder's syndrome." Not-for-profit organizations often begin with – and grow because of – a visionary founder. With this leader at the helm, the organization's board develops a corporate purpose, bylaws, and other important foundational documents. Typically, the board at least initially consists of the founder's friends and close associates. It is thus often natural for the founder to dominate the organization, rather than to have a capable board exercise strong governance. This may lead to many problems, including unintended breaches of fiduciary duties.

Founder's syndrome is primarily a conflict of interest issue for a person – often well intentioned and passionately committed – who exercises leadership so strongly that it results in undue influence over the organization, thereby weakening the effectiveness of other leaders and ultimately the organization itself. Frequently, an organization with founder's syndrome has a leader (or small group of leaders) who exercises a large degree of control, where little happens without that person's approval. Often, the bylaws lack board term limits, thereby allowing long-term directors to dominate the organization – albeit with good intentions. The board members are typically weak, acquiescing to the leader's control based on institutional history ("the way things work"), personal factors (perhaps too busy), or other reasons. Unfortunately, the person or persons in the "founder's" role may effectively strangle an organization by dominating it, even though it may seem such control is necessary in order to keep the organization working. Because of their weakened positions, the board members are unable to fulfill their duties of care and obedience.

The effects of founder's syndrome, if left unchecked, can be extremely detrimental. Often, otherwise qualified directors and employees either leave the organization when they run up against founder's syndrome, or they, themselves, become entrenched along with their leader. In serious cases, the organization will cease to function effectively and will be forced to go through a painful and often destructive transition. In effect, while a strong leader's control may greatly benefit an organization, it may later keep new talent from growing into effective nonprofit leaders and the organization may be crippled.

Steps to prevent or "cure" founder's syndrome include the following. First, an organization should recognize and address the problem as early as possible. Many not-for-profits do not have the apparent luxury of developing new leadership while they are providing programs, managing crises, and handling daily operational issues. However, such development is vital to long-term organizational health. Second, the organization's bylaws should limit board terms. This should energize the board with fresh ideas, enthusiasm, and resources from new directors. Third, other structural limits on the founder's control may be appropriate. Fourth, the organization should strive

© Mosher & Wagenmaker, LLC

to regularly provide leadership development, training, and delegation. Fifth, during transition periods, organizational leaders should work closely with the new leaders to promote a smooth succession. With a changing of the guard, an organization may wish to hire an interim executive, to allow time to identify and develop a new visionary leader. Sixth, founders and their supporters alike should beware of any sense of entitlement to the organization's bounty. Done improperly, payments to past leaders may result in improper conflicts of interest, possible excessive compensation tax issues, and wrongful diversion of charitable assets. Last, an organization should consider other ways to honor an outgoing leader, such as with an award or other show of appreciation.

III. LEGAL PROTECTIONS FOR DIRECTORS AND OFFICERS; LIMITED LIABILITY, INDEMNIFICATION, AND INSURANCE

In 1986, the Illinois Legislature responded to the demise of charitable immunity by passing a law limiting volunteers' personal liability. This law, as well as its federal counterpart, provides protection in many situations. However, because of serious gaps in the laws' coverage, volunteer directors and officers need additional protection through corporate indemnification and directors and officers' insurance, as described below. Notably, these laws provide no protection whatsoever for the not-for-profit organizations themselves.

A. Illinois Volunteer Director Liability Act

The Illinois Volunteer Director Liability Act (Illinois Act) grants volunteer directors and officers a form of limited immunity from certain types of civil liability. The Illinois Act serves a valuable function by giving well-intentioned, public-spirited people some relief from the worry that they could be sued for negligent actions that they cannot always control. Its immunity provisions shelter directors, officers and other people who serve not-for-profit organizations without compensation, but only to a limited degree. The scope of the Illinois Act's protection also is often misunderstood. Many directors and officers mistakenly believe they are immune from all civil law suits and related liabilities so long as they do not receive compensation. Other common misconceptions revolve around what actions are covered and what limitations apply.

For the Illinois Act's limited liability to apply, the following conditions must be present:

1. Persons must be serving a not-for-profit organization organized under the Illinois General Not for Profit Corporation Act;

2. The organization must either be tax-exempt under Internal Revenue Code Section 501(c) or otherwise qualify for exemption under federal law; and

3. Generally, persons must be serving such an organization without receiving compensation (other than reimbursement for actual expenses).

805 ILCS 105/108.70(a)-(c) (with allowance for up to $5,000 annual compensation for certain volunteers engaged in agriculture or professional, commercial, industrial, and trade associations).

Generally the Illinois Act's limited liability provisions are intended to protect directors and officers from unintentional torts, i.e. injuries resultant from "slip and fall" accidents, auto collisions, negligent services and the like. Accordingly, the Illinois Act provides protection from personal liability for "damages resulting from the exercise of judgment or discretion in connection with the duties or responsibilities" of such volunteer. 805 ILCS 105/108.70(a), (c). An exception exists, however, if the volunteer's act or omission at issue involves "willful or wanton conduct." Id. This term is defined as "a course of action which shows an actual or deliberate intention to cause harm or which, if not intentional, shows, an utter indifference to or conscious disregard for the safety of others or their property." 805 ILCS 105/108.70(d).

For example, if the Board approved the organization's use of a vehicle that they knew or should have known was unsafe, such approval could amount to the requisite "willful or wanton conduct" and subject each board member to personal liability (whether they were present or not at the meeting in which such use was approved). Likewise, a soup kitchen's board approval of food-handling policies that are clearly deficient could lead to personal liability of the board members. In addition, a director who slanders or libels another person through harmful false statements may be subject to personal liability, since this conduct is normally intentional and thus "willful."

The Illinois Act contains significant other exceptions from limited liability. For example, the Illinois Act does not shield volunteers from state and federal statutory liability, including federal employer tax liability rules, personal liability issues under the state sales taxes and unemployment insurance acts, laws intended to protect workers from illegal employment discrimination, and strict liability laws regarding environmental pollution. The Illinois Act also does not prohibit the filing of a lawsuit against a volunteer. Consequently, volunteers may have to incur substantial expenses for legal fees, not only to respond to allegations of wrongdoing but to mount a legal defense in the event a lawsuit is filed. As a result, indemnification and insurance remedies provide crucial additional protections.

B. Federal Volunteer Protection Act of 1997

The federal Volunteer Protection Act of 1997 (VPA) similarly protects volunteers from personal liability provided that certain conditions are satisfied. Specifically, the VPA requires the following:

1. The volunteer must be acting within the scope of the volunteer's responsibilities at the time of the act or omission;

2. If appropriate or required, the volunteer must be properly licensed, certified or authorized for the activities engaged in;

3. The harm must not be caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer, and

4. The harm must not be caused by the volunteer operating a motor vehicle, vessel, aircraft, or other vehicle for which the State requires the operator or owner to possess an operator's license or maintain insurance.

42 U.S.C. § 14501 *et seq*. Like the Illinois Act, the VPA contains several exceptions, and it does not prohibit the filing of lawsuits against volunteers. Id.

In light of the limited protections available under the Illinois Act and the federal VPA, directors and officers should seek additional benefits available through indemnification and insurance. In most cases involving allegations of volunteer wrongdoing, whether they lead to a lawsuit or not, the expenses related to hiring legal counsel to evaluate the case and to defend the individuals involved can be extremely expensive. Well-drafted indemnification provisions and adequate insurance coverage, however, can relieve this potentially significant financial burden for directors, officers and other volunteers. Indeed, before serving as a volunteer board member, a prudent person should ask about and confirm that sufficient indemnification and insurance coverage exists to protect him or her against claims of wrongdoing.

C. Indemnification

The Illinois General Not-For-Profit Corporation Act permits organizations to indemnify their directors, officers, employees and agents. 805 ILCS 105/108.75. To "indemnify" means to guarantee payment of damages and expenses of legal defense of lawsuits that arise from the acts of the corporation or its agents. Such indemnification is allowed if the person acted in good faith and in a manner that he or she reasonably believed to be in the best interests of the corporation. Id. In matters of criminal liability. the actor must have had no reasonable cause to believe that such conduct was unlawful. Id. Indemnification should be specifically authorized by the corporation, based on a determination that it is proper under all the circumstances. 805 ILCS 105/108.75(d).

While indemnification protection may be helpful, it is only as valuable as the extent of the organization's financial resources. Accordingly, to better protect both the organization's resources and its volunteers, the not-for-profit should obtain directors and officers' liability insurance. The Act authorizes such insurance coverage for claims asserted against directors, officers, and other agents in their official capacity or arising out of their status as such. 805 ILCS 108.75(g). Typically, directors and officers' liability insurance will cover both the individual's defense and any damages awarded. Coverage may not be provided, however, if the individual is held liable for illegal or other intentional acts of wrongdoing.

Directors and officers' insurance may be obtained from commercial insurance companies.

© Mosher & Wagenmaker, LLC

Alternatively, and likely more economically, insurance may be obtained from others. For example, several religious groups have formed insurance cooperatives to insure churches and related charitable and educational organizations at lower premiums than available commercially. In Chicago, a not-for-profit risk pooling trust exists to address the growing problem of insurance for not-for-profit organizations. See www.firstnonprofit.com. Not-for-profit groups thus may be insured at substantially lower premiums without sacrifice of coverage. By carrying insurance, the directors and officers also can be confident that their good faith services will not result in personal liability and that potential claims against them will not drain their organization's finances.

IV. Conclusion

Not-for-profit directors and officers serve critical roles as guardians of charitable organizations, keeping them true to their mission, financially sound, and effective in their operations. To promote the best interests of these organizations and to protect themselves from potential personal liability, directors and officers must fulfill their fiduciary duties of due care, loyalty, and obedience. As explained above, these duties affect every aspect of directors and officers' functions. In the event of claims of negligence or other wrongdoing, directors and officers can avail themselves of limited immunity under state and federal law, indemnification as permitted under Illinois law, and insurance coverage. These protections also will shield the organization's valuable charitable resources. By doing their jobs well and following these important safeguards, directors and officers can help their not-for-profit organizations to flourish and thereby can contribute meaningfully to society in countless ways.

O:\OfficeManagement\Website\Featured Articles\ARTI.D&O.wpd

© Mosher & Wagenmaker, LLC

APPENDIX A

CONFLICT OF INTEREST POLICY, POLICY AGAINST EXCESS BENEFIT TRANSACTIONS & POLICY REGARDING RESTRICTIONS ON FUNDS

Article I – Purpose

The purpose of these policies is to protect the interest of ___________________________ (the "Corporation") and its tax-exempt status when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director. This policy is intended to supplement but not replace any applicable state laws governing conflicts of interest applicable to Not-for-profit and charitable corporations.

Article II – Definitions

1. Interested Person. Any director, principal officer, or member of a committee with board delegated powers who has a direct or indirect financial interest, as defined below, is an interested person.

2. Financial Interest. A person has a financial interest if the person has, directly or indirectly, through business, investment or family:

a. An ownership or investment interest in any entity with which the Corporation has a transaction or arrangement, or

b. A compensation arrangement with the Corporation or with any entity or individual with which the Corporation has a transaction or arrangement, or

c. A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Corporation is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are substantial in nature.

A financial interest is not necessarily a conflict of interest. Under Article III, Section 2, a person who has a financial interest may have a conflict of interest only if the appropriate board or committee decides that a conflict of interest exists.

Article III – Procedures

1. Duty to Disclose. In connection with any actual or possible conflicts of interest, an interested person must disclose the existence of his or her financial interest and must be given the opportunity to disclose all material facts to the directors and members of committees with board delegated powers considering the proposed transaction or arrangement.

2. Determining Whether a Conflict of Interest Exists. After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he/she shall leave the board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

3. Procedures for Addressing the Conflict of Interest.

a. An interested person may make a presentation at the board or committee meeting, but after such presentation, he/she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement that results in the conflict of interest.

b. The President or committee chairperson shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.

c. After exercising due diligence, the board or committee shall determine whether the Corporation can obtain a more advantageous transaction or arrangement with reasonable efforts from a person or entity that would not give rise to a conflict of interest.

d. If a more advantageous transaction or arrangement is not reasonably attainable under circumstances that would not give rise to a conflict of interest, the board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Corporation's best interest and whether the transaction is fair and reasonable to the Corporation, and shall make its decision as to whether to enter into the transaction or arrangement in conformity with such determination.

4. Violations of the Conflicts of Interest Policy.

a. If the board or committee has reasonable cause to believe that a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.

b. If, after hearing the response of the member and making such further investigation as may be warranted in the

© Mosher & Wagenmaker, LLC

circumstances, the board or committee determines that the member has in fact failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action, including removal from the Board.

Article IV – Records of Proceedings

The minutes of the board and all committees with board-delegated powers shall contain:

1. The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the board's or committee's decision as to whether a conflict of interest in fact existed.
2. The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection therewith.

Article V – Compensation and Avoiding Excess Benefits

1. A voting member of the board of directors who receives compensation, directly or indirectly, from the Corporation for services is precluded from voting on matters pertaining to that member's compensation.

2. A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Corporation for services is precluded from voting on matters pertaining to that member's compensation.

4. Persons who receive compensation, directly or indirectly, from the Corporation, whether as employees or independent contractors, are precluded from membership on any committee whose jurisdiction includes compensation matters. No person, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

5. All compensation arrangements shall be reviewed by the Corporation at least every other year to assure that compensation is reasonable and is the result of arms length bargaining. Decisions regarding compensation shall be made only after the board or an appropriate independent committee examines relevant financial information regarding compensation received by similarly situated individuals for similar services performed. The board or appropriate committee shall examine the data on compensation paid by at least three comparable organizations in the same or similar communities for similar services (or at least five such comparable organizations in the event that the Corporation receives in excess of $1,000,000 during the current period during which compensation is set or during the previous accounting period). A copy of such relevant comparable financial information, including a description of how the data was obtained, shall be maintained as a part of the records of board or appropriate committee making such compensation decision.

Article VI – Annual Statements

Each director, principal officer and member of a committee with board delegated powers shall annually sign a statement which affirms that such person:

a. Has received a copy of the conflicts of interest policy,
b. Has read and understands the policy,
c. Has agreed to comply with the policy, and
d. Understands that the Corporation is a charitable organization and that in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

Article VII – Periodic Reviews

To ensure that the Corporation operates in a manner consistent with its charitable purposes and that it does not engage in activities that could jeopardize its status as an organization exempt from federal income tax, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

1. Whether compensation arrangements and benefits are reasonable and are the result of arm's-length bargaining.
2. Whether provider services result in inurement or impermissible private benefit.
3. Whether partnership and joint venture arrangements and arrangements conform to written policies, are properly recorded, reflect reasonable payments for goods and services, further the Corporation's charitable purposes and do not result in inurement or impermissible private benefit.
4. Whether agreements with other providers, employees, and third party entities further the Corporation's charitable purposes and do not result in inurement or impermissible private benefit.

Article VIII – Use of Outside Experts

© Mosher & Wagenmaker, LLC

In conducting the periodic reviews provided for in Article VII, the Corporation may, but need not, use outside advisors. If outside experts are used their use shall not relieve the board of its responsibility for ensuring that periodic reviews are conducted.

Article IX – Restrictions on Use and Disbursement of Funds
No contributions shall be made by the Corporation to any organization in which any director, officer or highly compensated employee has an interest, and no donor shall receive financial benefit directly or indirectly from any distribution made by the corporation.

______________________________	______________________________
[Name], President	[Name], Secretary
Date: _________________________	Date: _________________________

Date Policy Adopted: _______________________________

© Mosher & Wagenmaker, LLC

APPENDIX B

CONFLICT OF INTEREST
ANNUAL DISCLOSURE STATEMENT

All Directors, Officers, and key management employees of &CORPNAME& ("the Organization") should complete the following form on an annual basis. These forms should be retained with the Organization's other important corporate documents.

Please initial each statement that applies to you:

_____ I have read and am familiar with the Organization's Conflict of Interest Policy. I understand that a conflict of interest may arise of a financial or non-financial nature whenever I or any of my relatives has a personal interest that is or may be in conflict with the Organization's interests, such that I may be improperly influenced by personal interest when making a decision for the Organization.

_____ I am not aware of any direct or indirect financial or other material interest or co-investment interest that is required to be disclosed under the Conflict of Interest Policy.

_____ I have described below or in an attached letter every direct or indirect financial or other material interest or co-investment interest that is required to be disclosed under the Conflict of Interest Policy.

____

____

During the time I am in a position of corporate governance and/or management, I agree to report promptly any future situation that might involve or appear to involve me or any of my relatives in any potential conflict of interest with the Organization.

I am completing this disclosure statement based on the definitions below that are taken from the Organization's Conflict of Interest Policy.

Printed name: ______________________________________ Position: __________________

Signature: ____ Date______________________

© Mosher & Wagenmaker, LLC

Definitions

For the purpose of this Policy, a person has a **direct or indirect financial or other material interest** in a proposed or existing contract, transaction, or arrangement (collectively, "Arrangement") if he or she, or one of his or her relatives:

(a) has a substantial financial interest directly in the proposed or existing Arrangement; or
(b) has a substantial financial interest in any organization that i) is a party to the proposed or existing Arrangement; or ii) is in any way involved in the proposed or existing Arrangement, including through the provisions of services in connection therewith (an "involved organization"); or
(c) holds a position as trustee, director, officer, member, partner, shareholder, or employee in any such party or involved organization.

A Director's, Officer's, or key management employee's financial interest will be considered substantial if it involves:

(a) an ownership or investment interest representing more than 1% of the outstanding shares of a publicly traded company or 5% of the outstanding shares or comparable interest of a privately owned company with which the Organization has or is negotiating an Arrangement or which is an involved organization with respect to the Arrangement; or

(b) an ownership or investment interest, which produces a significant amount of income for or constitutes a significant part of the net worth of the Director or Officer, or a relative of the Director or Officer, as defined in the Policy, in any entity with which the Organization has or is negotiating an Arrangement or which is an involved organization with respect to the Arrangement; or

(c) a compensation Arrangement of any kind with any entity or individual with which the Organization has or is negotiating an Arrangement or with any involved organization with respect to the Arrangement.

Each Director, Officer, and key management employee of the Organization is also required to disclose whether he or she, or one of his or her relatives, has personal funds invested with an investment manager providing, or expecting to provide, investment management services to the Organization or in a professionally managed investment fund in which the Organization is invested or is considering investing (a co-investment interest"). For the purposes of this Conflicts Policy, a "professionally managed investment fund" shall not include mutual funds or other similar investment vehicles generally available to the investing public on essentially the same terms.

© Mosher & Wagenmaker, LLC