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# The Demanding Fiduciary Duties of Not-For-Profit Directors and Officers

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[34] *Id.* at 16-17.

[35] *Id.* at 18.

[36] *Id.* at 19.

[37] *Id.* at 21.

[38] Mass. Gen. Laws ch. 183, §63B (1994).

[39] Ga. Code Ann. tit. 44, § 14-1 (2008); Ohio U.C.C. 1349.21 (1996); Colo.Rev.Stat. §38-35-125 (1987); Neb. Rev. Stat. §44-19, 116 (2003); Wis. Stats. §708.10 (1995).

[40] N.C. Gen. Laws ch. 45A (1995); Tenn. Code Ann. ch. 47-32 (2005).



# THE DEMANDING FIDUCIARY DUTIES OF NOT-FOR-PROFIT DIRECTORS AND OFFICERS

by
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## INTRODUCTION

The presidents and boards of United Way[1] and Adelphi University[2] acted in manners which indicated that they either did not care or did not know the fiduciary standards which they needed to exercise. President William Aramony of the United Way of America spent the time of his tenure from 1970 through 1992 at this not-for-profit enterprise using its funds and resources in many cases for his own personal benefit. He appointed board members who were his friends, rewarded family members with jobs, rented limousines, took transatlantic flights and awarded contracts with scant thought of benefit to United Way. Adelphi University's president, Peter Diamandopoulos, in like manner, ruled the governing board of this not-for-profit entity during his tenure from 1985 through 1995. He misappropriated funds and lavished expenditures upon himself.

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Oftentimes, the officers and boards of not-for-profit corporations believe that the standards of responsibility required of them do not exact the same standards required of for-profit corporations. This paper emphasizes the fact that the not-for-profit corporation statutes of many states require the same standards of care, loyalty and obedience to law required of the officers and boards of for-profit corporations.[3] The legislation of many states, in fact, repeats the same words in each statute, whether applicable to not-for-profit or for-profit entities.[4]

## THE DUTIES OF GOOD FAITH, DILIGENCE, CARE AND SKILL

### *General Duties*

Every officer and director of a not-for-profit corporation must exercise the good faith, diligence, care and skill required of any ordinarily prudent person in like position under similar circumstances. The officer and director must actively participate in organizational meetings, evaluate reports, read minutes and review the work of those for whom they are responsible.[5]

### *Protection of the Business Judgment Rule*

Officers and directors of for-profit entities may rely upon the expertise of others to make a reasoned, conscious, good faith, uninterested and informed business judgment. This same standard of care applies to officers and directors of not-for-profit entities.

The officers and directors protect themselves through the exercise of the business judgment rule by practicing restraint and being diligent in avoiding hasty decisions. They should question and probe the information obtained from experts in order to assure themselves the presentations made to officers and board are accurate and sufficiently researched. This



deliberation will evidence the good faith and reasonableness of the officer and board decision. The minutes will accurately describe the record of the decisional process indicating the fairness of consideration paid and future effects of the decision upon the enhancement of the corporation.[6]

The Supreme Court of Minnesota, for example, upheld the use and protection of the business judgment rule in *Janssen v. Best & Flanagan*, decided on May 22, 2003.[7] George Janssen and others, members of the Minneapolis Police Relief Association (MPRA), brought a derivative action on behalf of the MPRA against the attorneys for the corporation, Best & Flanagan. The plaintiffs alleged that the corporation's attorneys committed malpractice by improvidently and improperly counseling MPRA to invest in a company known as Technimar. The venture lost approximately $15 million for MPRA.

MPRA was a not-for-profit corporation that administered a Minneapolis police officer's pension plan. It was subject to the Minnesota Non-profit Corporation Act and was governed by a board of directors. Janssen and the other plaintiffs needed MPRA to join in the suit, but special counsel hired by MPRA to investigate Janssen's claims determined that the association should not join the suit.

The Minnesota Supreme Court decided that the special counsel could certainly act as a special litigation committee of the association. The directors could reasonably rely upon that special counsel's decision that the attorneys for the board has not committed malpractice and that the board should not vote to join the association in the suit. But the Court decided that the directors did not reasonably act in reliance upon the special counsel's decision. That counsel, Robert A. Murnane, had never interviewed the plaintiffs or their attorneys, which he should have done as a fundamental obligation in reaching a prudent decision about the reasonableness of their complaints.

> Murnane also gave no indication that he had undertaken the careful consideration of all the germane benefits and detriments to MPRA that is indicative of a good faith business decision. Murnane opined that 'the totality of the materials reviewed does not support a finding that Best & Flanagan committed legal malpractice in its handling of the MPRA affairs,' and that 'to spend money in the pursuit of a legal malpractice claim against Best & Flanagan would not be prudent use of the MPRA funds.' The language of his conclusion hints that his decision was that of a special counsel evaluating the likelihood of a legal victory. But a much more comprehensive weighing and balancing of factors is expected in situations like this, taking into consideration how joining or quashing the lawsuit could affect MPRA's economic health, relations between the board of directors and members, MPRA's public relations, and other factors common to reasoned business decisions.[8]

The Court, therefore, held the directors liable for their failure of diligence, care, and skill.

*Directors' Duties to Participate Actively in Board Action*

Directors must also actively participate in assigned board and committee obligations, indicate written dissent from any board actions, have general knowledge of the books and records of the corporation and investigate reports or warnings of employee malfeasance.

Directors, in like manner, should ascertain the clear stated process for fundraising, the payment of professional fees and compensation and review for officers and employees. They must examine the monthly financial accounts and reports made available to board committees such as finance and audit. The



directors must compare actual expenditures to budgetary allocations, requiring an explanation of any discrepancies. They need to actively participate in risk assessment and strategic planning in order to initiate safeguards and controls through insurance and fidelity bonds. It is vitally important that the directors secure background checks for prospective employees, retain corporate records and protect whistleblowers. Equal opportunity for service should appear not only in the board but also in hiring practices.

*An Egregious Failure to Actively and Diligently Participate in Board Actions:* A 2005 decision of the Commonwealth Court of Pennsylvania, illustrates a failure of directors' duties to actively and diligently participate in board deliberations, particularly concerning matters of discriminatory practices in employee relations.

In *Spanish Council of York, Inc. d/b/a York Spanish American Center v. Pennsylvania Human Relations Commission*[9], the York Spanish American Center (Center) Executive Director, Vilma Garcia-Jones, began her duties in 1992 and served with its Assistant Director, Sterling Feeser, until their discharge in 1996. Feeser was responsible for supervising the Center program's effectiveness. He managed staff and assisted in fundraising. He sent a letter to staff noting certain performance shortcomings and suggested improvements; the letter did not identify specific employees, but a month later, he sent a warning letter to one of the employees for failure to manage her monthly hourly quota of cases as required by the Center's contract with York County. This employee complained about the letter to her brother-in-law, a member of the Center's board of directors. The Executive Director also received complaints about Feeser's strictness but she dismissed them, after investigation, as lacking merit.

Center board members then began to act individually and as a group to hear complaints about Feeser's management style without including either Assistant Director Feeser or Executive Director Garcia-Jones in the meetings. The Executive Director informed board members that these meetings were not in accord with specific Center grievance procedures for employee complaints. Board members nonetheless continued to hear the complaints without informing Feeser of the situation.

At an April 2, 1996 meeting of the board, the minutes recorded a concern that Feeser "was not the best person to act as director of the Center in the event of a vacancy in that position."[10] Garcia-Jones, present at the meeting, indicated that the board was violating the Center's employee handbook by permitting individual meetings between staff and board members. She was "shouted down" when she informed the board that references to Feeser's ethnicity were inappropriate. Although Feeser was fluent in Spanish and married to an Hispanic woman, several board members suggested that Feeser be eliminated because he was white. After the board meeting, staff members began using racial epithets toward Feeser; one board member stated "he is not Latino, he is only married to a Latino."[11]

On April 23, 1996, the board called a special meeting. A consultant, Dr. Jake Keller, was asked to evaluate the relationships between board, administration and staff. The report did not recommend discharging Mr. Feeser, but merely suggested a new grant writer position. (This position, however, was never advertised or filled.) The board, at the same meeting, voted to eliminate Feeser's position and the board president stated, "I needed to send a message to the staff that [the board] had heard their complaints and had acted upon them."[12] Feeser's position was eliminated effective June 26, 1996. Garcia-Jones objected to the process and warned of its impropriety, both in accordance with the procedures in the



employee handbook and in accord with the provisions of the state's Human Rights law forbidding discrimination based on race.

In September 1996, Feeser filed a complaint with the Pennsylvania Human Rights Commission; eight days after the complaint was served, the Center's board fired Garcia-Jones. She subsequently filed her own complaint with the Commission, asserting that her termination was prohibited retaliation. The Commonwealth Court decided that discriminatory practices had occurred against both Feeser and Garcia-Jones. The Court reasoned that board minutes, board members' conduct and board actions indicated a desire to discriminate on the basis of race and did not contain any consistent or reasoned statement concerning Feeser's supposed poor management style. Even if the Center had mixed motives, the motive which predominated was that of racial discrimination. Both Feeser and Garcia-Jones properly petitioned the Commission under the Act because they were (i) protected, (ii) qualified, (iii) suffered adverse employment action and (iv) were discharged in circumstances that inferred prohibited discrimination.[13] Failure of the Center's board and its members to follow basic guidelines of good faith, diligence, care and skill resulted in serious deleterious effects upon a not-for-profit corporation whose laudable mission included the fostering of citizenship and responsibility among the members of the Latin-American community in York, Pennsylvania.

*Heightened Internal Controls Required:* Recent statutes requiring additional diligence among board members and in board action have resulted in heightened internal control. Many not-for-profit corporations have prepared documents to comply with the oversight, internal control and code for ethics for financial professionals required of for-profit corporations by the Sarbanes-Oxley Act of 2002.[14] In order to comply with the Act, these not-for-profit corporations are in the process of creating an active and aware audit committee. The Chief Financial Officer and the Executive Director will publicly attest to the accuracy, completeness and fairness of the corporation's financial statements, to publicly disclose a code of ethics for senior management and the governing board, to have all audit work proved by the board audit committee and to examine closely all insider loans.[15]

THE DUTY OF LOYALTY

Officers and directors, if at all possible, should avoid conflict of interests. The not-for-profit organization, however, may enter a contract in which one of its directors has a material financial interest. The interest, however, must be fully disclosed to the board; the interested director must refrain from voting; and the transaction must be reasonable and fair on its face. Most boards, in fact, have instituted written policies concerning the avoidance of conflicts of interest.

A not-for-profit corporation, furthermore, should refrain from making corporate loans to directors, officers or their families, even though the statutes permit such loans in the reasonable expectation of benefit to the corporation.

Directors and officers, in like manner, should avoid corporate opportunities, which divert a not-for-profit entity's opportunities to personal gain of the director or officer. If the opportunity is available or suitable to the corporation, the officer or director may only take the opportunity if the corporation, after due deliberation, decides not to take the opportunity.

The duty of loyalty also requires directors and officers to comply with the organization's articles of incorporation and bylaws, its mission and purpose.

The duty of loyalty demands a curb upon self-dealing. Officers and directors often experience difficulty in complying



with this requirement. All of the cases cited above illustrate forms of self-dealing, especially failure to comply with the not-for-profit organization's purpose and emoluments to directors, officers and their families. Additional cases caution the board member to exercise loyalty, honesty, and fidelity.

In particular, *Fitzgerald v. The National Rifle Association of America*[16], describes a board's attempt to retain control over board membership itself. The plaintiff Fitzgerald and others petitioned the court to obtain an order requiring the defendant National Rifle Association (NRA) to publish certain advertising in its official journal, *The American Rifleman*, concerning Fitzgerald's candidacy for the NRA's board of directors. The District Court issued the order. It reasoned that freedom of the press and the contractual statement on the NRA's advertising rate card did not permit it to refuse the advertisement because the fiduciary duty of corporate directors includes the duty to ensure fair and open corporate elections. The court indicated that this fiduciary duty extended only to members of the organization which would include plaintiff Fitzgerald.

The NRA was organized under the laws of the state of New York pursuant to that state's not-for-profit corporation law. Its directors and officers owe a fiduciary duty to its stockholders, in this case the Association's membership, to conduct its affairs in good faith and to promote the best interests of the Association. Officers and directors cannot manipulate the affairs a corporation in order to obtain control for themselves and not for another. The District Court cited Justice Douglas's opinion in *Pepper v. Litton*:

> He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standard of common deceney and honesty … He cannot use his powers for

> his own personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitations that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis.[17]

## THE DUTY OF OBEDIENCE

The duty of loyalty to the organization's governing documents is reinforced by the directors' and officers' duty to obey those documents, including any corporate statement concerning conflict of interest and disclosure.

*Levandusky v. One Fifth Avenue Apartment Corp.*[18] reinforces the right of a not-for-profit cooperative governing board to use its business judgment and to comply with its cooperative apartment rules in order to enforce a "stop work" order. Tenant-shareholder Levandusky sought to install heating riser pipes which arguably could create problems elsewhere in the building's worn pipe system. The standard of review which the Court of Appeals applied to this enforcement of a building policy against a tenant-shareholder included both the business judgment rule, which stated that the board decision was reasonable in the circumstances. A concurring opinion additionally indicated that the decision by the board was certainly not arbitrary and capricious. Under both standards the cooperative board acted in accord with its governing documents. Alleged personal dislike of the tenant-shareholder by individual board members did not affect the reasonableness of the decision. In the circumstances, no evidence was adduced that the decision was arbitrary and capricious.



Officers and directors, additionally, should familiarize themselves with state and federal statutes concerning solicitations for the not-for-profit's charitable purposes; income, sales and use taxes; unemployment and worker's compensation duties; tax and financial reporting responsibilities; and not-for-profit corporation obligations in general to comply with statutory requirements.

*St. Bartholomew's Church v. The City of New York and the Landmarks Preservation Commission*[19] clearly illustrates a not-for-profit board's necessity to comply not only with its internal regulations but also with a local statute. The Court rejected the claim of St. Bartholomew's that the decision of the Landmarks Preservation Commission was an unconstitutional impingement upon the Church's First Amendment free exercise clause and establishment clause rights. The Court also indicated that the property building restriction did not constitute a government taking of property without just compensation in violation of the Fifth and Fourteenth Amendments.

The Rector, Wardens, and Members of the Vestry of St. Bartholomew's Church constituted its officers and directors. They sought to amend a previous designation of the Church and adjacent seven-story community house as a New York City landmark in accordance with the Landmarks law. The Church building would remain intact, but the community house would be replaced by a forty-seven-story tower in order to adequately meet the Church's purposes for its charitable programs.

The Court, however, agreed with the denial of any change in status for the Church and its community house. The denial was not a government regulation of religious beliefs as such; the free exercise of religion does not relieve any individual, officer or board from compliance with a valid neutral law of general applicability. The Landmark law, furthermore, did not so seriously restrict the church's ability to use its property as to constitute an unjust taking which would violate the Fifth and Fourteenth Amendments.

The officers and directors of St. Bartholomew's church, therefore, were compelled to comply with a valid local statute.

## CONCLUSION

Any practitioner who advises officers and directors of not-for-profit corporations must unequivocally state their duties to be careful, diligent and faithful, to be loyal, and to be obedient. The illustrative cases and statutes mentioned above vividly require these officers and directors to use skills commensurate with that of any ordinarily prudent person in like position under similar circumstances. Increasingly, these officers and directors will need to practice the same standards of care, loyalty and obedience to law required of the officers and board members of for-profit organizations.

## ENDNOTES

[1] See *U.S. v. Aramony* 88 F.3d. 1369 (1996)

[2] See *New York Times,* February 5, 1997, p. B1

[3] See, for example, American Bar Association, *Business Law Section Guidebook for Directors of Non-Profit Organizations* (1993), p. 21; the guidebook addresses the duties of directors, but may be equally applied to officers. These same guidelines are suggested for all states by Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation*, Belknap Press of Harvard University Press, 2004.

[4] See, for example, New York Not-for-Profit Corporation Law, Section 717, which repeats the language of the New York Business Corporation Law § 717:



NPCL § 717. Duty of directors and officers

(a) Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. In the administration of the powers to make and retain investments pursuant to section 512 (Investment authority), to appropriate appreciation pursuant to section 513 (Administration of assets received for specific purposes), and to delegate investment management of institutional funds pursuant to section 514 (Delegation of investment management), a governing board shall consider among other relevant considerations the long and short term needs of the corporation in carrying out its purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.

(b) In discharging their duties, directors and officers, when acting in good faith, may rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by: (1) one or more officers or employees of the corporation, whom the director believes to be reliable and competent in the matters presented, (2) counsel, public accountants or other persons as to matters which the directors or officers believe to be within such person's professional or expert competence or (3) a committee of the board upon which they do not serve, duly designated in accordance with a provision of the certificate of incorporation or the bylaws, as to matters within its designated authority, which committee the directors or officers believe to merit confidence, so long as in so relying they shall be acting in good faith and with that degree of care specified in paragraph (a) of this section. Persons shall not be considered to be acting in good faith if they have knowledge concerning the matter in question that would cause such reliance to be unwarranted. Persons who so perform their duties shall have no liability by reason of being or having been directors or officers of the corporation.

The American Law Institute Principles, Sections 3.01ff, have served as a model for New York and other state statutes.

[5] For a review of the fiduciary duties of officers and directors of not-for-profit corporations, see, for example, the *Minnesota Office the Attorney General Charities Division Report* at http://www.ag.state.mn.us/charities/charDuties.html and *New York State*

*Attorney General Charities Bureau Report* at
http://www.oag.state.ny.us/charities/charities.html

[6] See *Fiduciary Duties of Directors* by Kumi Yamamoto at
http://www.grahamdunn.com/whatsnew/articles/fiduciaryduties/fiduciary.asp

[7] 662 N.W.2d 876; 2003 Minn. LEXIS 278.

[8] 662 N.W.2d 876 at 889.

[9] 879 A.2d 391; 2005 Pa. Commw. LEXIS 397; 14 A.L.R.6th 779.

[10] 879 A.2d 391 at 394.

[11] 879 A.2d 391 at 395.

[12] 879 A.2d 391 at 396.

[13] 879 A.2d 391 at 398.

[14] *The Public Company Accounting Reform and Investor Protection* (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, 2002.

[15] Unpublished document of Inwood Community Services, 651 Academy St., New York, NY. Homepage available at
http://www.inwoodcommunityservices.com/home.htm

[16] 383 F. Supp. 162; 1974 U.S. Dist. LEXIS 6646.

[17] 308 U.S. 295 at 311, 60 S.Ct. 238 at 247.

[18] 75 N.Y.2d 530; 553 N.E.2d 1317; 1990 N.Y. LEXIS 753.

[19] 914 F2d 348; 1990 U.S. App. LEXIS 16005. Cert. denied 499 U.S. 905, 1991.



# NEW YORK'S NEW HOME EQUITY THEFT PREVENTION ACT

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## INTRODUCTION

The main stream media has been heralding a crisis in the sub-prime mortgage sector. Newspaper and television reports are replete with alarming news, leading viewers to believe that the current crisis developed overnight. The purpose of this paper will be to examine how this crisis is not an over-night phenomenon, but the result of a series of decisions that took place over a decade and which arose from a variety of factors that some have compared to the banking problems of the 1930's. This paper will also examine the vast repercussions these decisions have had on the entire U. S. economy, some of which are already showing in the retail sector. Finally, we will conclude with recent New York legislation meant to stave off at least a part of this crisis by enacting consumer protection legislation for purchasers of foreclosed properties. . .

### *Overview of the Fiscal Crisis*

One of the main culprits of the current financial crisis has been the lending financial institutions themselves.

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