Ohio State Bar Foundation

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A Primer
on
Board Fiduciary Responsibility

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I. The Environment.

A. Tax-exempt organizations are an increasingly regulated industry.

B. The current environment includes more vigorous review of activities, operations, finances and transactions by Congress, the Internal Revenue Service, state attorneys general, members of organizations, the general public and the media.

II. The Basics.

A. Tax Matters.

1. The Ohio State Bar Foundation (the "Foundation") is tax-exempt under Section 501(a) of the Internal Revenue Code as an organization described in Code Section 501(c)(3).[1]

2. The Foundation is classified as a "publicly supported public charity" under Code Sections 509(a)(1) and 170(b)(1)(A)(vi), which means that it derives its public charity classification through the receipt of support from the general public.

3. Foundation grants and distributions should be made in furtherance of Code Section 501(c)(3) purposes.

a. Code Section 501(c)(3) purposes include charitable, educational, scientific and literary purposes (collectively, "charitable purposes") and grants and distributions from the Foundation may be made to Code Section 501(c)(3) organizations organized and operated for charitable purposes.

b. Grants and distributions may also be made to organizations not described in Code Section 501(c)(3) (such as trade associations described in Code Section 501(c)(6) like the Ohio State Bar Association) as long as such grants are for charitable purposes and the Foundation retains control and discretion as to the use of grant funds and maintains records establishing that grant funds were used for charitable purposes. Revenue Ruling 68-469, 1968-2 C.B. 210.

B. Corporate Matters.

1. The Foundation is an Ohio nonprofit corporation.

2. The Foundation is governed by its Board of Trustees.

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[1] All references are to the Internal Revenue Code of 1986, as amended (the "Code"). Code sections will be referred to as "Code Section."

C. Role of Trustees.

1. The primary role of the Trustees is to manage the Foundation.

2. The primary role is satisfied by:

a. Setting policy, providing operational planning and maintaining the financial well being of the Foundation so that it can fulfill its charitable purposes; and

b. Delegating functions to full-time managers whom the Trustees must oversee and monitor.

III. Duties and Responsibilities of Trustees.

A. Trustees of the Foundation are fiduciaries with respect to the Foundation.

B. As fiduciaries, the Trustees are

1. Required to administer the affairs of the Foundation in a manner that furthers its charitable purposes; and

2. Prohibited from using the Foundation for personal gain.

C. Trustees must exercise their best care, skill and judgment in their management of the Foundation.

D. Accountability.

1. The Trustees are the ultimate decision-making authority of the Foundation.

2. The Trustees are accountable for the overall management and direction of the Foundation.

3. The Trustees are accountable to the Ohio Attorney General and the Internal Revenue Service.

E. The Bottom Line.

1. Trustees are required to participate in Foundation matters in an informed and knowledgeable manner in order to fulfill their fiduciary duties with respect to governance.

2. Following the duties of care and loyalty described below will ensure that this “bottom line” requirement is fulfilled.

3. Breaching either duty can result in removal from office and potential personal liability for loss or harm to the Foundation.

IV. Fundamental Duties: The Duty of Care and the Duty of Loyalty.

A. The Duty of Care.

1. Fundamentally, a “duty of attention.”

2. Focus is on process and manner in which decisions are made.

3. The duty of care requires that decisions are made in a deliberate and knowledgeable manner that includes, as appropriate, identifying and exploring alternatives.

4. Trustees must act in a reasonable and informed manner when participating in board decisions and engaging in the oversight of the Foundation’s officers and staff.

5. Standard of care: Act as a person would act under similar circumstances in the best interest of the Foundation.

6. Be informed.

a. Trustees should become familiar with the governing instruments of the Foundation, including articles of incorporation, code of regulations (bylaws), committee reports, staff reports and board resolutions, which are the framework for Trustees responsibilities and duties.

b. Trustees should understand the role and powers of Trustees, officers, committees and staff.

c. Trustees may reasonably rely on staff reports and experts as needed.

d. Trustees may use and reasonably rely on financial advisors, attorneys and consultants as needed.

7. Participate.

a. Trustees should attend meetings and adhere to the Foundation's processes and procedures during such meetings.

b. Ask questions.

i. Trustees should ask questions particularly if a Trustee is not familiar with the topic under discussion, needs more facts or does not understand need for corporate action.

ii. Decisions by the Board should be made after the Trustees understand the need for action, and have addressed alternative courses of action and potential consequences of differing actions.

8. Delegate and Monitor.

    a. Trustees may (and should) delegate duties to officers, staff, committees and agents to handle and address day-to-day management and affairs of the Foundation.

    b. Trustees must prudently select officers, staff, committee members and agents and reliance on such officers, staff and agents must be reasonable.

    c. Trustees must monitor the activities of officers, staff, committee members and agents.

9. Exercise Independent and Reasonable Judgment.

    a. Trustees should use their own experience and background.

    b. Trustees should evaluate independently any position taken by another Trustee, officer, staff member or outside expert.

    c. Trustees must act all times in the best interest of the Foundation when making decisions.

10. Protection: Best Judgment Rule.

    a. The best judgment rule (the nonprofit analogue to the for profit business judgment rule) is a legal doctrine holding that as long as a Trustee acts in an informed manner, in good faith and in the honest belief that an action was taken in the best interest of the Foundation, a rebuttable presumption arises that the decision was made with due care and a Trustee will not be liable for such decision.

    b. Unless there is evidence to rebut the presumption, each Trustee will be shielded from liability for the decision, even if the decision is later determined to have been wrong.

B. The Duty of Loyalty.

1. The duty of loyalty means that a Trustee must put the interests of the Foundation first, ahead of his or her own interests.

2. The duty of loyalty requires discharge of Trustee duties unselfishly and in a manner that benefits only the Foundation and not a Trustee personally.

3. Inherent in the duty of loyalty is a duty to disclose situations which may present a conflict with the mission of the Foundation.

4. The duty of loyalty relates to: (i) conflicts of interest; (ii) self-dealing; (iii) corporate opportunity; (iv) confidentiality; and (v) obedience to the mission of the Foundation.

5. Conflicts of Interest.

    a. The duty of loyalty requires that a Trustee be conscious of potential conflicts and that a Trustee act with candor and care in dealing with any conflict.

    b. A conflict of interest occurs when there is a real or apparent incompatibility between a private interest and the fiduciary duty owed to the Foundation as a Trustee.

6. Self-dealing.

    a. Self-dealing occurs when a fiduciary engages in a transaction with the assets or property over which he or she has a duty of care, such as the assets of the Foundation.

    b. For example, if the Foundation is purchasing a new computer system, self-dealing may arise if the Foundation seeks to purchase the new computer system from a company owned by the spouse of a Trustee.

    c. Conflicts that could result in self-dealing must be discussed.

    d. Non-participation.

        i. If a Trustee has a personal interest in a transaction, such Trustee is disqualified from participating in any vote on the transaction.

        ii. Disclosure of the personal interest is required.

        iii. Discussion of a personal interest is permitted, but the interested Trustee should be excluded from discussion and vote on the transaction.

    e. Trustees should also be aware of the application of the “excess benefit transaction” rules of Code Section 4958, which applies a penalty tax on excess economic benefits conferred on Foundation “insiders.”

7. Usurpation of Corporate Opportunity.

   a. A Trustee may not take a business opportunity that is developed by, belongs to, or comes to the possession of the Foundation.

   b. The Foundation may choose not to use or take advantage of a corporate opportunity. If so, a Trustee may utilize the opportunity, but only if there is full disclosure to the Board.

8. Presumptions.

   a. When a Trustee transacts business with the Foundation, the transaction must be fair to the Foundation.

   b. The Trustee has the burden of showing fairness if challenged.

9. Confidentiality.

   a. A Trustee of the Foundation should treat as confidential all matters involving the Foundation until there is public disclosure or a matter becomes common knowledge.

   b. Public disclosure of Foundation matters generally is done through a spokesperson, such as the president or executive director of the Foundation.

   c. Exception: A Trustee may not ignore what he or she believes to be illegal activity or criminal conduct.

10. Obedience to the Mission of the Foundation.

   a. The duty of loyalty includes a requirement of obedience to the mission of the Foundation.

   b. A Trustee of the Foundation must be faithful to the purposes and goals of the Foundation.

   c. In general, absent illegal activity or criminal conduct, a Trustee of the Foundation should not criticize or “second guess” decisions made by the Board.

V. Minimizing Personal Risk.

A. Limited Liability Protection.

1. The Ohio Nonprofit Corporation Act provides that a trustee of an Ohio nonprofit corporation like the Foundation is not liable for any damages resulting from any act or omission or from the exercise of his or her

judgment in connection with his or her role as a trustee unless the act or omission involved was willful or wanton.

2. This generally precludes actions against a Trustee of the Foundation personally for negligence.

3. This provision does not protect the Foundation from liability for the negligent acts or omissions of the Trustees.

4. There are limits on the liability protection in cases of breach of the duty of care and/or duty of loyalty described above.

B. Indemnification.

1. Ohio law permits nonprofit corporations like the Foundation to indemnify Trustees and others against reasonable legal expenses incurred, judgments and fines imposed and/or amounts paid in settlement arising out of any civil or criminal litigation brought against them.

2. Indemnification by the Foundation requires having acted in good faith.

C. Protection of Trustees Through Insurance.

1. The Foundation can maintain directors and officers insurance.

2. Insurance generally covers:

   a. Wrongful termination.

   b. Race and sex discrimination, impermissible retaliation and false imprisonment.

   c. Libel, invasion of privacy and copyright infringement.

   d. Plagiarism.

3. Insurance generally does <u>not</u> cover:

   a. Breach of contract.

   b. Fines and taxes.

   c. Dishonest or fraudulent acts, or willful violation of a statute.

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