Legal Duties of the Nonprofit Board

Prospective board members may ask Tim and Claire about what the law expects of nonprofit board members. How much are directors expected to know about the finances and day-today running of the organization? Will directors be held liable if the board makes a poor decision or relies on bad advice? Is it permissible for a board member to work for another entity that does business with K-Child?

Even seasoned board members are sometimes surprised to learn that they have legal duties to the organization and may incur legal liability as a result of their board service. It is only fair that directors have the opportunity to understand and evaluate both the benefits and risks of being a member of a nonprofit board. Accordingly, they should be educated about their legal obligations and provided with ongoing information on the subject before they agree to stand for election.

A director has three legal duties under the Arkansas Nonprofit Corporation Act of 1993: the duty of loyalty, the duty to act in good faith, and the duty of care.[1] These duties are derived from the law of for-profit corporations and the legal standards are basically the same.

The duty of loyalty

The duty of loyalty requires directors to act at all times in the best interest of the organization and always put the organization's interests above their own. To ensure that directors comply with the duty of loyalty, a nonprofit should establish policies and procedures to address potential conflicts of interest between the organization and its directors.

A conflict of interest is created when a discussion or action of the board might result in a direct personal benefit to a director or create a situation in which the director's loyalties might be divided. The Arkansas Nonprofit Corporation Act of 1993 defines a conflict of interest as a transaction with the corporation in which a director has either a direct or indirect interest.[2] A direct interest would involve a potential loss or benefit to the director herself. An indirect interest occurs when another entity in which the director has an interest is a party to the transaction.[3] Examples of direct or indirect interests include: a director serves on the board of two nonprofits that are competing for the same grant or contract, an organization is accepting bids for construction of low-income housing and one of its directors works for a contractor that is interested in the job, a nonprofit's insurance agent serves on its board (the agent has a direct interest in decisions involving insurance), and a director's friend or

family member applies for a job with the organization. If an organization cannot determine whether a director has a conflict of interest concerning a particular matter, it may be prudent to consult an attorney.

How can K-Child and other nonprofits prevent such conflicts? First, they can avoid choosing board members who have obvious conflicts, such as close relatives of staff members, those who serve on the boards of organizations that compete with them for grants or contracts, and individuals who have connections to entities that might do business with the organization. Second, they can have a comprehensive conflict-of-interest policy.[4] A sample conflict of interest policy is provided in Appendix B. Third, each director should be asked to complete and sign a conflict-of-interest statement each year. Finally, each board member should disclose conflicts of interest when they arise and recuse from discussion and decision-making that creates a conflict.

Another way that directors should exercise their duty of loyalty is by not divulging confidential information about the organization. The common-sense key to fulfilling the duty of loyalty is to put the organization's interests before personal interests.

The duty to act in good faith

To act in "good faith" essentially means to be honest, above-board, and to act in a reasonable manner.[5] For example, to attempt to manipulate others in service of a secret purpose would not be acting in good faith. If a director honestly believes his actions are in the best interest of the organization, and tells the truth about his motivations, he is probably acting in good faith. The duty to act in good faith is sometimes viewed as a duty independent of the duties of care and loyalty, while others find that the duty to act in good faith is incorporated into the duty of loyalty.[6] When treated separately, the duty to act in good faith might be used to impose liability upon a director who recklessly misleads members, yet lacks a conflict of interest.[7] In other words, the director has acted unreasonably but has not violated the duty of loyalty. It is unclear whether Arkansas law views this duty as a freestanding duty or as an extension of the duty of loyalty.

The duty of care

The duty of care requires a director to act "with the care an ordinarily prudent person in a like position would exercise under similar circumstances."[8] "Prudent" means cautious, careful and sensible. So, to the extent that an average, ordinary person would be cautious under a certain set of circumstances, a

person acting in his role as director of a nonprofit organization is expected to conform to that standard of care.

As a practical matter, the duty of care means that directors must be reasonably informed and participatory. They must pay attention, ask questions, and oversee the management of the organization in a responsible manner. Directors should review minutes, financial statements, audits, plans, policies and other board documents. Ignorance is no excuse. In fact, failure to attend meetings and participate in the decision-making process increases the possibility that a director will be held personally liable for an act of the board or the organization.

In discharging the duty of care, a director may rely on information and opinions provided by certain people the director reasonably believes to be reliable and competent, including officers, employees of the organization, attorneys, public accountants, and committees of the board.[9] If the director knows that such reliance is unjustified, then acting on the information or opinions provided is acting in bad faith.[10]

The business judgment rule

The business judgment rule applies to nonprofit and for-profit corporations. Under the rule, nonprofit directors generally will not be held liable for action or inaction taken in the role of director

as long as they fulfill their legal duties, acting in good faith and consistent with their duties of care and loyalty.[11] Directors are not required to make the best decision every time, or even a particularly good decision. The law recognizes that governance involves a great deal of judgment and discretion. Directors are expected to make reasonable efforts to be informed and to follow the organization's established decision-making process. A board can decrease the possibility of adverse legal consequences of a controversial or difficult decision by making a serious effort to inform itself and discussing the matter thoroughly before taking a vote. The minutes should reflect these activities, so directors can show that they met their duty of care.

Functions of the Nonprofit Board

In order to be successful, K-Child's board will need to understand what it is expected to do for the organization. Although not all of the possible functions of a nonprofit board are discussed here, the authors have attempted to touch on the board responsibilities most vital to compliance with applicable law. The board should carry out all of these functions in compliance with the duties of good faith, care, and loyalty and with the use of good business judgment.

Providing for the recruitment and training of board members

Tim and Claire may be in a hurry to fill K-Child's board slots, but time and effort spent in recruiting the right board members ultimately will benefit the organization's mission. Before they start recruiting, Tim and Claire should be able to answer some basic questions such as what the organization intends to accomplish and what will be expected of its board members. Tim and Claire should be able to communicate their enthusiasm for K-Child's mission in a few sentences. They also need to have a clear understanding of what the K-Child board should look like, what characteristics, skills and talents will enable the group to fulfill its mission.

Once elected, K-Child board members will need orientation and ongoing training. Initial orientation should include: a thorough grounding in the history and mission of K-Child; a review of governing documents, policies and procedures; programs; and a presentation about the purpose, legal duties, and role of the board of directors. Board training should not stop there. One way for K-Child to develop the knowledge and skills of board members would be to set aside some time at each meeting for board training, even if only a few minutes. The directors themselves might volunteer to brush up on specific topics and provide a review for their fellow board members.

Like most nonprofits, K-Child will probably establish term limits for its board members. Therefore, recruitment of future board members will be an ongoing process.

Deciding and protecting the organization's mission

Mission is the heart of any nonprofit organization. A clear understanding of mission is very important to the organization's board, because one of the board's fundamental responsibilities is to ensure that all of the organization's resources are used to further the mission.

Every board member, employee and volunteer should be able to express the organization's mission in a sentence or two, with enthusiasm. If donors and other members of the community can do the same, that is even better. For this reason, most nonprofits have a short, written statement of their mission. A common-sense approach to creating a mission statement is for the board to discuss the organization's purpose, approach and values, and then to assign one or two members to draft several possible mission statements for the board to consider. Once the organization has a written mission statement, the board should review it annually.

Establishing governance policies and procedures

The board is responsible for creating and abiding by governance policies and procedures. Polices generally refer to rules or guidelines established by the board, while procedures describe how to implement policies.

Rules of Order

One of the first decisions K-Child's board must make is how it will conduct its business as a group. Some nonprofits seem to pride themselves on the informality of their decision making. The agenda, developed and distributed beforehand, is largely ignored as the meeting gets into full swing. Every voice is heard and sometimes several are heard at once! A development committee report that was allotted fifteen minutes on the agenda turns into an extensive discussion of the pros and cons of golf tournaments as fundraising events. A meeting that was planned for two hours lasts for three; decision-making continues as participants with other commitments make their apologies and dribble out. Although informal decision-making may work for very small groups, the failure to adopt and follow standardized rules of order can severely undermine the effectiveness of a nonprofit organization. Too much informality is inefficient and can drive orderly, results-oriented people away from an organization.

To avoid that problem, a board should adopt and follow rules of order. The *Modern Rules of Order* by Donald A. Tortorice is a good choice for many small and mid-sized boards. Available from the American Bar Association (*www.abanet.org*, click on "Web Store"), the *Modern Rules* are shorter and simpler than the better-known *Robert's Rules of Order*, but meet the needs of most organizations. The *Modern Rules* would be a good choice for an emerging organization like K-Child.

Larger boards may choose *Robert's Rules of Order*, a well known system of parliamentary procedure. *Robert's Rules* offer several benefits. They are widely known and accepted. Because they have been around a long time, *Robert's Rules* have been supplemented and revised numerous times and they cover just about any situation a nonprofit is likely to encounter. Unfortunately, the completeness of *Robert's Rules* creates a burden. They are long and complicated; consequently, many groups believe they are using *Robert's Rules*, but end up with a homegrown variation that is confusing and inconsistent. A group using *Robert's Rules* should consider appointing a parliamentarian who will study the *Rules* and help the organization's leaders use them correctly. The official *Robert's Rules of Order* website, *www.robertsrules.com*, is a good resource.

Bylaws

Bylaws are a nonprofit's primary governing document. They establish the procedures by which the organization will conduct its business. Bylaws must comply with state and federal requirements, but the law allows substantial leeway for the organization to govern and manage itself in a manner appropriate to its mission and activities. Therefore, an emerging nonprofit should be wary of copying the bylaws of another organization or delegating the entire task of creating bylaws to an attorney or other outside individual. The actual drafting may be done by one person, but the entire board should discuss and decide on key provisions such as the number of board members, the length of their terms, and voting procedures. All directors should be familiar with the bylaws and take responsibility for seeing that the organization follows them. For an outline of subjects typically covered in bylaws, see Appendix C.

Minutes

Like most nonprofits, K-Child probably will elect a secretary who will be responsible to see that written minutes of each board meeting are prepared, distributed, approved and retained in a safe place. Board minutes are important governance documents because they document the work and

decisions of the board. Many nonprofits also retain minutes of committee meetings. Boards often assign the task of preparing, distributing and retaining minutes to staff members, but the ultimate responsibility for these important functions remains with the board.

Code of Ethics

All nonprofit boards should consider adopting a code of ethics describing the ethical principles by which the organization seeks to operate. A sample code of ethics is available from the Independent Sector, *www.independentsector.org*, but no sample should be adopted as is. The organization's board and staff members should be involved in creating a code that reflects the unique values and outlook of the organization itself.

Policy Manual

Some organizational policies and procedures will be set out in separate documents such as bylaws. Others may be imbedded in minutes or other documents approved by the board. For example, if K-Child's board decides that the organization will always purchase liability insurance to cover injury resulting from a K-Child event, the directors have made a statement of policy. The board and staff will be better able to comply if policies

are gathered together in a separate document or manual that references the board minutes reflecting their adoption.

Establishing management policies and procedures

The board's role in the development of management policies and procedures will depend on many factors, including the size of the organization and the number of staff. Day-to-day management of a nonprofit is generally left to the staff, if there is one. The board, however, should exercise final approval over all important policies and procedures. An employee handbook, for example, is a critical document, since employment-related disputes are a common source of legal problems. Therefore, the board should approve the employee handbook and may want to hire an attorney to review it.

Recruiting, advising, supervising and evaluating top management

Hiring a chief executive may be the most important task a board undertakes. In addition to following general legal and ethical requirements related to hiring, a nonprofit board has a responsibility to hire the very best chief executive available. Toward that end, a board should make a careful examination of the state of the organization and its current needs before beginning a search. Directors may want to survey compensation packages offered by similar groups in order to attract good candidates.

Hiring can be complex and selecting the right chief executive is critical to the success of an organization. Therefore, a board may want to seek assistance from a paid consultant, board member, or other volunteer who is familiar with the hiring process.

The board should provide its chief executive with clear goals and priorities that lend themselves to regular evaluation. The chief executive also needs ongoing support and cooperation from the board. Usually the board chair takes the lead in this function. Alternatively, the board may appoint a small committee to work directly with the chief executive.

Participating in a continual process of organizational planning and evaluation

Planning and evaluation are essential to the responsible use of an organization's resources. In addition, many donors want to know what the organization has accomplished. The planning process enables the board to establish measurable goals and objectives that support its mission. Evaluation measures progress towards those goals and objectives.

Depending on the size of the nonprofit, the requirements of its funders, and the complexity of its activities, a nonprofit may need to hire a consultant to help with planning and evaluation. This can be a good use of organizational funds because donors, particularly those who make substantial grants, are often

attracted to programs that can show concrete, measurable results. Evaluation professionals are skilled in structuring an organization's activities so that results can be quantified and reported. Although the board may not be directly involved in program evaluation, it must be informed enough to ensure that the organization's resources are used in service of its mission.

Assuring the organization's financial accountability

Financial "accountability" refers to the idea that an organization's financial activity should be ethical, easy to monitor, and easy to understand. A nonprofit receives its tax-exempt status based on the understanding that it is dedicated to providing a benefit to the public, so it must be able to show that it is using its resources and assets in furtherance of its charitable purpose. In order to maintain financial accountability, the board of directors should review financial reports and policies frequently. The board should review financial data with an eye toward ensuring that: (1) officers are not misusing funds and resources; (2) officers' compensation is reasonable; (3) the organization is being properly managed; and (4) the financial objectives are being met.

K-Child, like other nonprofits, will probably need to recruit and maintain a finance committee that is familiar with its financial records and management systems. The board of a tax-exempt organization is often made up of people from diverse backgrounds with different skills and expertise. Nonprofits tend to look for board members who have positions of influence in the community, represent key populations, and can raise money.[12] However, these people do not necessarily have any expertise in the area of financial oversight. Nonprofits should make sure that they have some people with business and financial skills on the board. A strong, active finance committee will guide the board of directors in understanding of the organization's financial reports and documents, making it easier for the board to maintain financial accountability and transparency.

A nonprofit board should also consider having an annual independent audit. Some funders require an audit, which is an examination of the financial statements of an organization by a qualified person outside of the organization.[13] An independent audit helps to ensure that the organization's financial statements accurately portray its financial position. Additionally, an audit adds credibility to the organization's financial statements. If the board decides to hire an independent auditor, it should appoint an audit committee or ask the finance committee to oversee the process. An audit committee's duties include, but are not limited to: (1) selecting the audit firm; (2) reviewing and approving the scope and cost of the audit; (3) keeping a direct line of communication with the auditor; (4) reviewing the financial

statements provided by the board; and (5) making suggestions for improving the financial statements.

Arkansas law establishes standards that nonprofit and governmental organizations must follow when managing and investing institutional funds.[14] For example, a governing board may spend as much of an endowment fund as it "determines to be prudent," but only for the "uses and purposes" for which the fund was established.[15] When a donor has restricted the use of his donation, the organization must comply with the restriction and cannot release it without the written permission of the donor or, if the donor is unavailable, the permission of a circuit court with jurisdiction over the matter.[16] This is a complex and changing area of the law, so organizations should seek expert advice if they have any question about the permissible investment or use of institutional funds.

Developing, approving and monitoring the organization's budget

A budget is a financial plan. In most nonprofits, the board works with the staff of the organization to set goals and develop a plan for achieving those goals. The plan, when expressed in dollar terms, is the organization's budget. The board should begin to prepare and review the budget well before the start of the organization's fiscal year so that there is plenty of time to discuss plans for fundraising and spending. Depending on the

size of the organization and its programs, the board may need to seek input from the staff several months before it considers the final budget for approval. Often a substantial portion of a nonprofit's revenues comes from sources such as grants and individual donations, which can be difficult to predict. For that reason, some organizations develop alternative budgets, also called "contingency budgets," in addition to the expected budget.[17] Contingency budgets reflect various circumstances that the organization may encounter, such as an unusually large grant or the loss of past funders.

Raising money to support the organization

Many nonprofits require each board member to raise a certain amount of money each year. Others do not expect their directors to be involved in fundraising at all. Nevertheless, it is the responsibility of the board to ensure that the organization has sufficient funds to carry out its mission. The board generally sets fundraising goals and priorities. The board must also ensure that all fundraising on behalf of the organization is done in a manner that is legal and ethical. Most fundraising professionals insist that every nonprofit board member make an annual financial contribution, on the theory that it is unseemly to ask for money to support an organization's mission if the board members themselves do not contribute.

Representing the organization to the public

Board members are ambassadors of a nonprofit. They should be able to talk in a general way about the organization's mission, programs and achievements. When a specific issue arises, however, the board should identify a spokesperson to discuss that matter with the public. This is particularly important if the issue is controversial or complex or if the media is involved. No individual board member should claim to speak for the organization without authorization from the board.

Endnotes

[1] ARK. CODE ANN. § 4-33-830(a) (Repl. 2001).
[2] ARK. CODE ANN. § 4-33-831(a) (Repl. 2001).
[3] ARK. CODE ANN. § 4-33-831(b).
[4] *See* ARK. CODE ANN. § 4-33-831.
[5] *See, e.g.* ARK. CODE ANN. § 4-72-202(8) (Repl. 2001).
[6] Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 Md. L. Rev. 398, 408 (2007).
[7] *Id.*
[8] ARK. CODE ANN. § 4-33-830(a)(2).
[9] ARK. CODE ANN. § 4-33-830(b).
[10] ARK. CODE ANN. § 4-33-830(c).
[11] ARK. CODE ANN. § 4-33-830(d).
[12] *What a Difference Nonprofits Make: A Guide to Accounting Procedures*, Accountants for the Public Interest 11 (2001).
[13] *What a Difference Preparation Makes: A Guide to the Nonprofit Audit*, Accountants for the Public Interest 3 (1992).
[14] ARK. CODE ANN. § 28-69-601 *et seq.* (the Uniform Management of Institutional Funds Act).
[15] ARK. CODE ANN. § 28-69-603.
[16] ARK. CODE ANN. § 28-69-608.
[17] *What a Difference Nonprofits Make: A Guide to Accounting Procedures*, Accountants for the Public Interest 37 (2001).

CHAPTER III

Theories of Liability and The Nonprofit Board Member

K-Child's Directors Get Together, Get Excited, and then Get Worried

The newly-elected K-Child Board of Directors got together for the first time at a reception hosted by Mayor Hightower. Tim and Claire had done a great job of recruiting and the three incorporators had a hard time choosing nine new directors from a field of twenty-five well-qualified and willing candidates. The directors were a lively group, full of energy and enthusiasm and eager to make K-Child a success. They chatted excitedly about their vision of the future of Little Dipper, which would boast the healthiest children in Arkansas.

Following the reception, the directors convened their first official meeting. After rigorous discussion, the board adopted the following statement of mission:

K-Child promotes the good health of Little Dipper children and youth by providing nutritional information and recreational opportunities for children, youth and their families.

The mood became serious when Ron Lee, the owner of a Little Dipper sporting goods store, Fitness Frontiers, asked about the liability of nonprofit board members. "I'm all for this project. I have kids of my own and I sure want to see them get away from those computer games and be more active. Still, I have to admit I'm

a little hesitant to serve on this board. Am I opening myself up to getting sued? I don't want to lose my home, or my business, over this."

Introduction

Many nonprofit directors are concerned about how their board service might hurt them, especially in the pocketbook. Board service is a big responsibility and it involves a certain amount of risk. Fortunately, the law provides the conscientious director with some protection, which will be discussed in this chapter. Nevertheless, a good director asks questions about legal liability, for her own protection and the benefit of the organization. Before jumping into a discussion of risks, it will be helpful to discuss the concept of liability itself and review the broad legal areas from which liability could arise.

The Meaning of Liability

Liability generally means the state of being obligated or accountable. For example, an individual or organization may be liable to perform a certain act or to pay money. A legal liability usually is enforceable through the courts.

Theories of Liability

The following summaries are not comprehensive and do not take the place of legal training. Brief overviews such as these do not examine all of the nuances related to these complex legal concepts. This synopsis is intended to help nonprofit organizations stay out of legal trouble and to realize when they might need the assistance of an attorney.

Contracts

A contract is simply an agreement between two or more parties. A "party" can be either an individual or an organization, such as a business or a nonprofit organization. Some contracts, like a purely social agreement to meet for lunch, are not legally enforceable. If properly formed, business-type contracts are enforceable in a court of law. Examples include agreements to buy, sell, lease, or perform certain work. Although people often use the word "contract" to refer to a written document, an enforceable contract may be oral, written, or even implied from the circumstances.

Suppose K-Child enters into a contract with Theo. K-Child agrees to pay Theo $2,000 to paint K-Child's facility by the end of the month. K-Child pays Theo. At the end of the month Theo has not fulfilled his promise to paint K-Child's facility. K-Child

may file suit against Theo for breach of contract. Unless Theo has a legal excuse, such as fraud or an unexpected event leading to the impossibility of performance, the court probably will hold Theo liable for breach of contract. In any event, Theo likely will be liable to K-Child for the $2,000 payment.

Negligence and Gross Negligence

Simply put, negligence is "the failure to do something that a reasonably careful person would do" or "the doing of an action that a reasonably careful person would not do."[1] Liability for a negligent act is grounded in a legal concept known as the "duty of ordinary care."[2] Generally, individuals have a legal duty to use the level of care that a reasonably careful person would use under the circumstances. Certain relationships, such as a parent and child or a teacher and student, heighten the duty one person owes to another. The duty of ordinary care will apply to most volunteer activities. An individual or organization that fails to use ordinary care, and in doing so harms the person or property of another, may be liable for negligence.

Gross negligence is the failure to use even slight care.[3] If someone participates in an act of gross negligence, that person is considered to have acted with "carelessness or recklessness to a degree that shows utter indifference to the consequences

that may result."[4] Clearly, gross negligence is worse, and more punishable, than ordinary negligence.

Intentional Torts and Criminal Acts

Intentional torts are intentional acts that interfere with the person or property of another. They include assault, battery, false imprisonment, intentional infliction of emotional distress, and trespass. The most important distinction between negligence and intentional torts is based on the meaning of "intent." While there are different ways to define "intent," for legal purposes the focus is on whether someone knew or was fairly certain that the particular consequences would result from his or her conduct. "Intent," however, does not require intent to cause harm to someone or something.

For example: Suppose K-Child has organized a 5K run to raise money and to encourage the children and adults of Little Dipper to be more active. Antonio, a spectator, is waiting at the 2-mile mark of the 5K. He is looking for his friend Nancy. When he spots her he decides it would be funny to hit Nancy with a water bottle – not to hurt her, but only to catch her attention. There are hundreds of people running in the 5K, several running very close to Nancy. Antonio throws the water bottle at Nancy. The bottle hits Jade, another runner, who trips, falls, and sprains her ankle. Although Antonio did not mean to

harm Jade, if Jade can prove that Antonio should have known that the water bottle would hit someone running near Nancy, Antonio likely would be liable to Jade for battery. K-child would not be liable to Jade unless the organization itself was negligent or committed an intentional wrong through the act of one of its "agents," such as a director or employee.

Generally, "indemnification" and other insurance coverage do not cover liability arising from intentional torts and criminal acts. Indemnification is discussed later in this chapter.

Defamation

A false statement of fact that tends to, or is reasonably calculated to, damage another's reputation may form the basis of a lawsuit for defamation.[5] Written defamation is called libel; spoken defamation is slander.[6] In order to prove a claim of defamation, the plaintiff must show: (1) that the statement was defamatory; (2) that the statement identified or referred to the plaintiff; (3) that the defendant "published" the statement (he communicated the statement verbally or in writing to someone besides the plaintiff); (4) that the statement was false or misleading; and (5) that the plaintiff was damaged.[7]

Nonprofit organizations, by nature of their activities, can be exposed to defamation claims. Some common scenarios out of

which a defamation claim may arise are: statements published in the organization's newsletter or on its website, statements made by a staff member during a speech, and providing references on former employees. Since the statement must have been false or misleading, truth is an absolute defense to a defamation claim. In other words, a truthful statement cannot be defamatory. The plaintiff making the defamation claim has the burden of proving that the statement was false.

There are several steps that a nonprofit organization can take to prevent defamation suits from being filed against it and to mount a strong defense if such a suit is filed. First and foremost, when responding to requests for information about a former employee, the organization should provide only minimum information, such as the employee's dates of employment and whether the employee is eligible for re-hire. Furthermore, the organization should limit access to personnel and client files. The organization should adopt a reference policy so that: (1) potential employees are aware that the organization may request references from former employers and provide references to subsequent employers and (2) the organization has a procedure for giving truthful, verifiable references and for keeping records of the information it provides in response to a request for information. The organization also should have a procedure for verifying the truth of potentially defamatory statements

before providing the information on its website or dispensing the information in a speech. It would be a good idea for the organization to determine whether it has insurance coverage for defending defamation claims. Lastly, it is always a good idea to obtain legal review of potentially defamatory material before the organization publishes it.

Liability and the Nonprofit Board Member

Liability of Board Members for Their Own Actions

Arkansas law imposes legal duties on every board member, as discussed in Chapter II. If a board member fulfills his legal duties of good faith, care and loyalty, he is not liable to third parties, or to the organization, for anything he did or did not do in his capacity as a board member.[8] Of course, if a board member does not exercise the duty of care and engages in an act or omission constituting negligence, he can be held personally liable for the damage he caused.[9] Additionally, a board member can be held personally liable if he commits an intentional tort.[10] An example of an intentional tort would be a board member getting into an argument with a volunteer, then grabbing the volunteer's cell phone out of her hand and smashing it.

Liability of Board Members for Actions of Employees or Other Board Members

Arkansas has a tort liability immunity statute in place that is specifically intended to shield board members from liability for the negligence of others.[11] This statute acknowledges that nonprofit organizations provide valuable services and assistance to Arkansans and encourages people to serve on the board of directors of such organizations so that they may function effectively.[12] Thus, board members are not personally liable for damages resulting from an employee's negligent act or omission or another board member's negligent act or omission.[13] However, if a nonprofit organization sells alcoholic beverages, beer, or wine, Arkansas law is unclear on whether board members will continue to enjoy the protection of the tort liability immunity statute.[14]

To demonstrate how this immunity would shield board members from liability, consider the following. Suppose K-Child has an after-school program for children. K-Child maintains a list of the authorized caregivers who may pick up the children in the program. One afternoon a woman named Judy comes to pick up one of the children, Tina. Judy is not one of the people authorized to take Tina. Unfortunately, the K-Child staff member in charge did not check the list and releases Tina to Judy. The staff member committed an act of negligence, perhaps

even gross negligence. Nonetheless, the board of directors cannot be held liable for that staff member's negligence. K-Child, on the other hand, may be held liable depending on whether it is entitled to charitable immunity. (For more on charitable immunity, see Chapter VI.)

Liability of Board Members for Conflict of Interest Transactions

As mentioned in Chapter II, the board member's duty of loyalty includes the duty not to engage in conflict of interest transactions. A conflict of interest transaction is a transaction between the board member and the organization from which the board member (or a relative of the board member) could directly or indirectly realize a personal benefit. However, simply because a board member engages in a conflict of interest transaction does not mean that she will be liable to the organization. In the following situations a board member's participation in a conflict of interest transaction will not create liability for the board member: (1) the transaction was fair to the organization at the time it was entered into; (2) the material facts of the transaction and the board member's interest were disclosed or known to the board of directors and the board authorized, approved, or ratified the transaction; or (3) the material facts of the transaction and the board member's interest were disclosed or known to the members of the organization and they authorized, approved, or ratified the transaction.[15]

To be certain that board members are able to recognize and avoid harmful conflict of interest transactions, nonprofit organizations are strongly encouraged to adopt conflict of interest policies. A conflict of interest policy describes how the organization will handle disclosure of conflicts of interest, the duty to disclose a conflict or a potential conflict, and the actions to be taken after disclosure. It is designed to prevent persons with decision-making authority from taking actions that benefit themselves, members of their families, or their business and corporate affiliates. While the main purpose of a conflict of interest policy is to prevent board members from engaging in transactions that are not in the organization's best interest, it serves other valuable functions. Such a policy is a way for the organization to assure the IRS that no unwarranted benefits are conferred on officers and directors; this is important because an organization's tax-exempt status can be jeopardized if it provides unwarranted benefits, or excess benefits, on its officers and directors. Additionally, if the board adopts and is dedicated to implementing a conflict of interest policy, the board members can assure themselves that they are fulfilling their duties of care, loyalty, and the duty to act in good faith. Lastly, when a nonprofit organization has a conflict of interest policy in place, and abides by the policy, donors and the public community are more likely to have confidence in the

organization's integrity, honesty, and mission. See Appendix B for a sample conflict of interest policy.

Liability of Board Members for Unlawful Distributions

Under Arkansas law a "distribution" is the payment of a dividend or any part of the income or profit of an organization to its members, directors, or officers.[16] Arkansas law only permits distributions under certain circumstances. An organization that is a mutual benefit organization may make distributions in order to purchase its memberships but only under certain conditions.[17] An organization is also permitted to make distributions upon dissolution, provided the organization complies with the laws governing dissolution.[18] And lastly, an organization may make distributions if the organization is organized and operated as a "cooperative."[19]

If a board member agrees to or votes for a distribution not permitted by law, she will be personally liable to the organization for the amount of the distribution that exceeds the permissible amount.[20] For example, suppose that Tim, a board member of K-Child, has been sued because he recommended that K-Child hire a child care worker who later turned out to be negligent in supervising children in the after school program. Tim made the recommendation in good faith and fulfilled his duties of care and loyalty, so Claire and other board members decide that K-Child

should reimburse Tim for his legal expenses, plus a weekly stipend of $2,000 to cover his transportation, meals, and other expenses related to the lawsuit. Under Arkansas law, K-Child is permitted to reimburse Tim for *reasonable* expenses that he incurs during trial.[21] The $2,000 weekly stipend probably is not a reasonable expense. Therefore, Claire could be personally liable to K-Child for the amount of the weekly stipends paid to Tim.

However, Claire would *not* be personally liable for those distributions if, when authorizing the distributions, she complied with the legal duties described in Chapter II, the duty to act in good faith, the duty of care, and the duty of loyalty. Also, if Claire is held liable for the unlawful distributions, she would be entitled to reimbursement (1) from every other board member who agreed to or voted for the distribution without having complied with his or her legal duties, and (2) from each person who received an unlawful distribution, who, in this case, would be Tim.[22]

Indemnification

Indemnification means that one entity agrees to cover certain losses to another. The Nonprofit Incorporation Act of 1993 allows a nonprofit to indemnify a director or employee who is made a party to a lawsuit or criminal proceeding because of her service to the organization if the director or employee meets all