Taking Advantage of "Limited Liability"

How to Stay Out of Trouble
As a Board Member of a Non-Profit Corporation

PART ONE:
POTENTIAL LIABILITY TO OUTSIDE CREDITORS

- Lets face it, the main reason people form corporations is so that they can undertake risky activities without having to face personal liability in case there is a lawsuit.

- **Normally directors and officers are immune from liability for corporate acts.** As a general rule the courts will allow corporate creditors with court judgments to seize only corporate owned property. Thus, the courts will not allow creditors to "pierce the corporate veil" and seize property (or money) owned by shareholders, members, directors, and officers.

- **EXCEPTION:** the courts ***will*** allow creditors to "pierce the corporate veil" and seize personal assets where it is found that the corporation has ***not*** followed the formalities required of a corporation but, instead, has acted as if it it was just the alter ego of the individuals who control it. This occurs when:

- The corporation takes actions without the board of directors having granted formal authority

- Corporate assets have not been segregated from the assets of directors. Example, the corporation uses office space owned by a director without a formal (board authorized) lease, or, the corporation pays debts using a director's credit card.

- A MODEST PROPOSAL: FOLLOW THE "CORPORATE FORMALITIES": A corporation should, in fact, act like a corporation.

- HOW DECISIONS *SHOULD* NOT BE MADE: Corporate decisions should not be made informally over coffee or over the telephone by two or three of the key people in the organization. Officers have no authority to act on behalf of the corporation unless the board has actually passed a resolution giving him or her such authority.

- THE PROPER WAY TO MAKE DECISIONS: The only way that a corporation can legally take any action is for the board directors to pass a resolution at a meeting where a quorum is present.

- PROXY VOTING IS NOT ALLOWED: Directors cannot act by proxy. The board must actually meet in order to take action. There are two exceptions: Boards can act by unanimous written consent without actually having to meet. Also, boards can meet via telephone conference call or through a tele-video conference if all of the board members participating can hear each other.

- Each director is presumed to assent to board action unless the minutes show that he or she dissented or abstained.

- KEEP MINUTES OF EACH MEETING AND STORE THEM IN A CREDIBLE "MINUTE BOOK": Why bother acting like a corporation if you can't prove it later. Will you be left standing there naked when the lawsuits start to fly? Why not avoid all of that embarrassment and legal liability? Here's an novel idea: KEEP MINUTES of each meeting and store them in something that actually looks like a real minute book!!!

- AVOID THE NEWSLETTER SYNDROME WHEN KEEPING MINUTES: The minutes are not the corporation newsletter. Try to limit the minutes to the essentials. By avoiding unnecessary wording you will find that minutes are a lot easier to keep (i.e. don't try to capture every word that is said at a meeting). You may, however, occasionally find it desirable to include some limited background discussion in order for the reader to understand the particular corporate action being considered by the board.

- LIMIT MINUTES TO A RECORD OF FORMAL BOARD ACTION. When someone makes a motion the minutes should tell whether or not the motion was adopted. They should state who voted against the motion or abstained. DO NOT put in extra details. DO NOT summarize the discussion (for or against) that took place prior to the vote. DO NOT include names (except for the names of those who voted against it or abstained.
- THE MINUTE BOOK: The minutes should be collected into a "minute book" (a three ring binder is recommended).
- MINUTES SHOULD BE FORMALLY ADOPTED: A standard item on the agenda of each and every board meeting should be the adoption of minutes from prior meetings. This serves several purposes. Corrections can be made at that time. The motion to adopt minutes also serves as a reminder of what actions were taken at the prior meeting and gives the board a chance to reconsider or to make modifications
- THE MINUTE BOOK SHOULD BE COMPLETE: the minutes book should offer a complete paper trail of every board meeting from the very beginning until the present.

TWO WAYS TO PROVIDE ADDITIONAL PROTECTION FOR BOARD MEMBERS

- **Officer and Director Liability Insurance Policy**: Corporations can purchase liability insurance to protect directors from the possibility that they will be sued in court and found to be personally liable for acts of the corporation. Such insurance, of course, may be expensive.
- **Indemnity Clauses**: under Florida law, corporations have the power to "indemnify" directors and officers against liability incurred as a result of their activities on behalf of the corporation (so long as the officer or director acted in good faith and in a manner that he or she reasonably believed to be in the best interest of the corporation). To "indemnify" means that the corporation will reimburse the officer or board member for all losses and expenses that he or she might incur as the result of a law suit. Indemnity provisions are usually placed in either the articles of incorporation or the bylaws. They can also be put into effect by a resolution of the board of directors.

THE ROLE OF OFFICERS

- Shocking News for Officers -- “Officers have no inherent authority!!!!” The only authority officers have is what is given to them by a vote of the board of directors or in the bylaws.
- Officers are merely agents.
- What is an Agent: An agency relationship is formed when two persons agree that one of them (the "Agent") is to act for the benefit of the other (the "Principal").
- Because corporations are artificial persons, they can act only through their "agents". Anyone can become an agent of the corporation if the board of directors gives them authority. Officers are merely potential agents. The bylaws given them a fancy title, but, unless the board actually grants authority the officers have no authority (other than authority given in the bylaws previously adopted by the board). .
    - Agents Face No Personal Liability, provided they act with proper authorization. Thus, officers

are immune from liability unless they act without board granted authority.

- Officers are Merely *Potential* Agents: Officers don't become actual agents until the board of directors has granted authority.
- Two Type of Authority: Agent can have two possible kinds of "authority" giving them the power to legally bind the principal
    - Actual Authority: Actual Authority exists where the corporation (the "Principal") expressly authorizes the Agent to take a specific action on its behalf pursuant to a resolution of the board of directors. In such cases, the agent faces no personal liability when things go wrong.
    - "Apparent Authority": Even where there is no actual authority, it is possible for a former agent of the corporation to contractually bind the corporation. This occurs where the corporation (the "principal"), by its past behavior and conduct, has led innocent people to believe that a particular person had authority to take certain actions. Whenever a corporation takes authority away from a former agent it should inform the people with which it does business of the change. Where there is apparent authority, the principal may be legally bound by the actions of the former agent. The former agent, having no actual authority, could be found to be personally liable.

PART TWO:
POTENTIAL LIABILITY OF DIRECTORS TO THE CORPORATION

NEGLIGENCE: under traditional rules of corporate law, board members can be held personally liable for corporate debts if the act negligently

- **"BUSINESS JUDGMENT RULE**": Directors are protected from negligence liability if they act reasonably and in good faith for what they believe to be the best interests of the corporation. In other words, directors are not liable for honest mistakes or errors of judgment.
    - The business judgment rule does not apply to the following situations: negligent management, breaches of fiduciary duty (see below), fraud, and taking actions which exceed the corporation's purposes
- **HOW A DIRECTOR CAN AVOID BEING "NEGLIGENT**": Inattention to business is negligence. Each director has a duty to attend meetings and to keep well informed on the status of corporation matters. Directors must familiarize themselves on the financial condition of the corporation. Board members may, however, rely on information given to them by the staff, officers, the corporation's accountants, etc. (unless they have reason to suspect that this information is wrong).
- **STATUTE GIVES INCREASED PROTECTION TO NONPROFITS**: In 1986 the Florida legislature gave board members and officers of tax exempt, nonprofit corporations additional protection from liability. Now, it takes more than mere negligence to find a board member personally liable. Section 617.0834, Florida Statutes states that such officers and directors will not be personally liable for money damages unless they breached or failed to perform their duties, and this breach or failure to perform amounted to one of the following:
    - a violation of the criminal law, or
    - the board member received "improper personal benefit", or
    - the breach or failure to perform the duty was done "recklessly" (i.e. with conscious

disregard of a known risk) or done in "bad faith" or done pursuant to a "malicious purpose", or done in manner exhibiting wanton and willful disregard of human rights, safety, or property.

WHAT DUTIES CAN BOARD DELEGATE

- Boards of directors have ultimate responsibility for the management of the a corporations. The most important responsibility of the Board: hiring the chief executive officer.
- What can be Delegated: As a practical matter, boards delegate day to day management authority to its chief executive officers and his or her staff What should not be Delegated: Boards should not delegate a reviews of program plans and budgets and they should delegate an evaluation of the program's effectiveness.

BREACH OF A "FIDUCIARY DUTY" : Each board members owes a legal duty of good faith, full disclosure, fair dealing, and undivided loyalty to the corporation. In other words, directors must positively renounce anything that is unfair. The fiduciary duty imposes a duty that is higher than the morals of the workaday world, the marketplace, and the trodden crowd.

- PURPOSE OF FIDUCIARY DUTY: The purpose of the fiduciary duty is to remove all temptation since it recognizes the weakness and frailty of human nature. A breach typically occurs where directors or officers self deal to their own benefit and to the detriment of the corporation. The affected board member in such a situation has a potential for divided loyalties
- TYPES OF FIDUCIARY DUTIES: Breaches of the fiduciary duty typically arise in five contexts:
  - <u>Competing with the corporation</u> (violates that fundamentals of duty of undivided loyalty).
  - <u>Usurpation of corporate opportunity</u>: directors cannot divert for themselves business opportunities that rightfully belong to the corporation.
  - <u>Disclosure of Confidential Information</u>
  - <u>Actively working to destroy or harm the organization</u>: Board members who want to destroy the corporation or do it harm by speaking to the press or bad mouthing it should first resign from the board of directors.
  - <u>Conflict of Interest:</u> this potentially can occur whenever the corporation is considering entering into a contract with one of its board members (e.g. a lease, an employment contract, sale of stock, etc.).
- How Do We Safeguard Against Conflict of Interest? When the personal or professional concerns of a board member or a staff member affect his or her ability to put the welfare of the organization before personal benefit, conflict of interest exists. Nonprofit board members are likely to be affiliated with many organizations in their communities, both on a professional and a personal basis, so it is not unusual for actual or potential conflict of interest to arise.* the breach or failure to perform the duty was done "recklessly" (i.e. with conscious disregard of a known risk) or done in "bad faith" or done pursuant to a "malicious purpose", or done in manner exhibiting wanton and willful disregard of human rights, safety, or propert
- Why must we be concerned about conflict of interest? Board service in the nonprofit sector carries with it important ethical obligations. Nonprofits serve the broad public good, and when board members fail to exercise reasonable care in their oversight of the organization they are not living up to their public trust. A 1974 court decision known as the "Sibley Hospital case" set a precedent by confirming that board members can be held legally liable for conflict of interest because it constitutes a breach of their fiduciary responsibility
- To avoid problems with Conflicts of Interest:, the minutes should show (1) that the board member

disclosed the potential conflict, (2) that there was a full discussion about how the proposed deal was in the best interests of the corporation, and (3) that the board member with the conflict abstained from the vote. The bottom line, however, is that the proposed transaction must actually be in the best interest of the corporation.

PART THREE:
POTENTIAL LIABILITY TO THE IRS FOR UNPAID EMPLOYEE WITHHOLDING TAXES.

What happens when a nonprofit, charitable, corporation has cash flow problems and instead of paying the payroll taxes when due, they use the money to pay other bills. Under what circumstances would individual board members or staff be personally liable for the overdue payment?

OVERVIEW OF FEDERAL PAYROLL TAXES: Part of the federal social security payroll tax (FICA) is paid by the employer and part is withheld from the employee's paycheck. The part paid by the employer is a corporate and not a personal liability.

"RESPONSIBLE PERSONS" MAY FACE PERSONAL LIABILITY: The amounts collected from employees are treated differently. Their portion of FICA withholding were held by the corporation in trust for transmittal to the federal government. If the corporation cannot pay, the IRS will seek payment from the responsible directors and employees.

Responsible persons are considered those who have the power to see that the taxes are timely paid. In determining whether a person has such power, the courts have examined the following criteria, any one of which may be sufficient: (1) corporate bylaws, (2) authority to sign checks, (3) responsibility to sign employment and other tax returns, (4) authority to make payment to other creditors, (5) power to hire and fire, (6) officer status, and (7) overall supervisory control of corporate finances.

A person can be considered responsible even though he or she did not participate in the decision or did not actually authorize or write the checks to the other creditors. The test is whether the person had the power of control, not whether that power was exercised. Responsibility does not end because of failure to attend meetings.

To be liable, a responsible person must have willfully failed to make the payment. Willfulness here does not require a bad motive. It only requires a voluntary, conscious and intentional failure to pay over the withheld taxes. Willfulness exists despite a good faith expectation that the taxes would be paid later.

Often, a corporation has more than one responsible person. The government may collect the full unpaid amount from any one or from less than all. Those who pay may seek contribution from those who do not, if state law permits. Insurance coverage, whether from a corporate general liability policy or an individual directors and officers liability policy, usually is not available.

SAFETY PRECAUTIONS: To minimize the possibility of personal liability, establish a finance committee to regularly review the timely payment of all corporate tax.