Trustee Liability & Whistleblowing

Darren B. Moore
Bourland, Wall & Wenzel, P.C.
Fort Worth, Texas

Presented to:
2016 Salk Institute Breakthrough Biomedical Philanthropy Seminar
La Jolla, California
May 12, 2016

The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein. Nonlawyers are advised to consult an attorney before undertaking issues addressed herein.

All written material contained within this outline is protected by copyright law and may not be reproduced without the express written consent of Bourland, Wall & Wenzel.

© 2016 Bourland, Wall & Wenzel, P.C.

DARREN B. MOORE
Bourland, Wall & Wenzel, P.C.
301 Commerce Street
Fort Worth, Texas

Phone: (817) 877-1088
Email: dmoore@bwwlaw.com
Twitter: @darrenbmoore
Blog: moorenonprofitlaw.com

Mr. Moore practices with Bourland, Wall & Wenzel, P.C., a Fort Worth, Texas law firm which represents individuals, closely held and family businesses, professional practices and charitable organizations within its areas of legal practice. Mr. Moore was born in Lubbock, Texas on December 11, 1973. He earned a B.A., cum laude, from Texas A&M University and his J.D., magna cum laude, from Baylor Law School where he served as Editor in Chief of the Baylor Law Review.

Mr. Moore was admitted to practice law in Texas in 2000 and before the United States District Court, Northern District of Texas and United States Tax Court in 2001. He is a member of the State Bar of Texas; Tarrant County Bar Association; American Bar Association (Business Law Section, Section of Taxation); College of the State Bar; and is a Fellow of the Texas Bar Foundation. He was named a "Rising Star" by Texas Super Lawyers from 2009 – 2013. Mr. Moore was selected as a "Top Attorney" in Nonprofit Law by *Fort Worth, Texas* magazine in 2013 and 2014.

Mr. Moore's practice focuses on representation of nonprofit organizations and social enterprises. Mr. Moore advises clients on a wide range of tax and legal compliance issues including organization of various types of nonprofit and social enterprise entities, obtaining and maintaining tax-exempt status, risk management, employment issues, governance, and other business issues, as well as handling IRS audits, attorney general investigations, and litigation matters on behalf of his exempt organization clients.

Mr. Moore is an adjunct professor at Baylor Law School where he has taught Nonprofit Organizations since 2001. He has been a guest lecturer at the University of Texas School of Law and Southern Methodist University Dedman School of Law on nonprofit organization topics. Additionally, he writes and speaks regularly on tax and legal compliance issues. Mr. Moore is co-author of the third edition of Bourland, Wall & Wenzel, P.C.'s publication, Keeping Your Church Out of Court.

The author gratefully acknowledges the other attorneys at Bourland, Wall & Wenzel, P.C. working in the area of tax-exempt organizations for their advice and contributions to earlier versions of this paper.

TABLE OF CONTENTS

I. INTRODUCTION **1**

II. STATE STANDARDS OF CONDUCT **1**

A. WHAT LAW APPLIES 1

B. FIDUCIARY DUTIES 2

1. Generally *2*

2. Duty of Care *3*

3. Duty of Loyalty *7*

4. Duty of Obedience *10*

5. Standing to Bring a Complaint *11*

C. OTHER BASES OF LIABILITY 12

D. A NOTE ON GOVERNANCE 13

III. FEDERAL STANDARDS OF CONDUCT **13**

A. GENERALLY 13

B. PRIVATE INUREMENT 14

C. PRIVATE FOUNDATIONS: PROHIBITED TRANSACTIONS 14

1. Self-Dealing *14*

2. Jeopardizing Investments *20*

3. Taxable Expenditures *20*

IV. PROTECTION FOR DECISION MAKERS **21**

A. IMMUNITY 21

B. INDEMNIFICATION 21

C. INSURANCE 22

D. INFORMATION 22

TRUSTEE LIABILITY & WHISTLEBLOWING

I. INTRODUCTION

Serving as a decision maker in a business enterprise carries an unavoidable element of risk whether the organization operates for profit or as a nonprofit. Persons injured by or simply unhappy with the decisions made may seek to complain and hold the decision maker responsible. Within the nonprofit realm, and more particularly for purposes of the present discussion, within the realm of nonprofits recognized as exempt and classified as private foundations, decision makers must look to both state and federal law to identify the standards to which they will be held. This paper, focusing on directors and trustees of private foundations, proposes to highlight the standards to which these decision makers are held under both state law as well as federal tax law thereby identifying the restraints they face in the performance of their duties. In providing such information, the goal of the paper is to identify the proverbial rules of the game, thereby providing decision makers the ability to govern their conduct to avoid penalties both to themselves as well as to the organizations which they serve.

II. STATE STANDARDS OF CONDUCT

A. WHAT LAW APPLIES

The choice of legal form begins the analysis of what standards apply. In general, nonprofit organizations, particularly those seeking to qualify as exempt from federal income tax under § 501(c)(3) of the Internal Revenue Code (the "Code"), fall into one of four categories: (1) charitable trust; (2) nonprofit corporation; (3) nonprofit unincorporated association; or (4) limited liability company (the LLC being available only in limited circumstances). Creators of private foundations invariably choose the trust or corporate form.

A charitable trust is a fiduciary relationship with respect to property whereby property is held in trust for charitable purposes. The Restatement of Trusts describes it as a "fiduciary relationship with respect to property arising as a result of the manifestation of an intention to create it, and subjecting the person by whom the property is held to equitable duties to deal with the property for a charitable purpose."[1] Texas law defines a charitable trust as "a charitable entity, a trust the stated purpose of which is to benefit a charitable entity, or an inter vivos or testamentary gift to a charitable entity."[2] Charitable trusts are the oldest type of nonprofit entity tracing their roots back to the Statute of Charitable Uses of 1601.[3] A charitable trust is created by a settler irrevocably transferring property to a person or entity as trustee with the intention of creating a trust. Under Texas law, charitable trusts are directed by one or more trustees. Charitable trusts are governed by the Texas Trust Code, which includes provisions specifically

[1] *See Restatement of Trusts* § 348.
[2] *See* TEX. TRUST CODE § 123.001(2).
[3] *See* 43 Elizabeth, Chapter 4 (England 1601).

addressed to charitable trusts.[4] In addition, a large body of common law exists in the area of charitable trusts.

While states differ in their definition of a nonprofit corporation, the key characteristic is the prohibition on distribution of profits to members, directors, or officers in the form of dividends or otherwise.[5] Nonprofit corporations may be member organizations or non-member organizations (a decision largely related to control) but are generally governed by a board of directors with states having various rules on the minimum number of directors. Some states (such as Texas) provide that a nonprofit corporation may be governed by its members rather than a board. In the private foundation context, this is typically used as a control feature or a legacy feature.

The corporation may also designate any one or more individuals to be advisory members of the Board of Directors. An advisory member of the Board of Directors is entitled to notice of all meetings and has the right to attend the meetings, but does not have the right to vote unless he or she is specifically given that right in the governing documents. Sometimes these individuals are called ex officio directors, though that terminology may or may not refer to a voting director. If the advisory director is not given the right to vote, then neither will he or she have the duties or liabilities that are imposed by law on the other directors. In other words, a person serving as an "honorary director" or in some sort of advisory capacity carrying no right to vote is not subject to the full panoply of duties identified in this paper. This can be a helpful solution to the need to include additional voices for fundraising or in another advisory capacity. Of course to the extent a person serves as a non-voting, ex officio member of the board by virtue of being an officer of the corporation, the lack of a vote will not relieve that individual of his fiduciary obligations stemming from his role as an officer.

B. FIDUCIARY DUTIES

1. Generally

While the power to act for the organization is typically vested in a Board of Directors or Board of Trustees acting collectively, each director owes certain fiduciary duties to the organization. A fiduciary duty is simply a duty to act for someone else's benefit while subordinating one's personal interests to that of the other person.[6] Fiduciary duties are grounded in equity and influenced by the fact-specific and context-intensive flexibility of the law of equity. As such, different rules apply depending on the context, i.e. the relationship between the fiduciary and the beneficiary. Fiduciary law, including that applicable to directors and trustees, has largely developed at common law with various aspects subsequently codified in state trust and corporate statutes. Because the elements of a breach of fiduciary duty claim are (1) the existence of a duty; (2) breach of that duty; and (3) injury to the principal or benefit to the fiduciary, understanding the nature of the duty and what constitutes a breach is paramount. For example, while both trustees and corporate directors owe fiduciary duties as a matter of law, because directors are not trustees, the duties owed by directors differ (at least in application)

---

[4] *See* TEX. TRUST CODE § 123.001 et seq.

[5] *See, e.g.,* Tex. BOC § 22.001(5).

[6] *See* BLACK'S LAW DICTIONARY 625 (6th ed. 1990).

from those owed by trustees.[7] As such, a practitioner must be careful to distinguish case law based on the form of the entity in question.

Trustees owe fiduciary duties to the beneficiaries of the trust. In the context of a charitable trust, the duty is owed to named charitable beneficiaries, if any, and more broadly to the public in charity. Accordingly, both the named beneficiaries as well as the state attorney general have standing with respect to claims for breach of fiduciary duty. Directors of corporations owe a strict fiduciary obligation to the corporation as a matter of law. In the charitable context, directors owe fiduciary duties to the corporation they serve and to the public in charity. While the same person may owe similar duties to other organizations (consider an individual who serves on the board of both a grantor and a grantee) creating a duality of interest, when making decisions as a director, the person owes allegiance to the corporation being served. Of course this may at times present a conflict, which will be discussed below. Charitable fiduciaries stand in the unique position of being the keeper of the organization's assets and the guardian of the organization's mission. This unique role plays itself out in the duties of care, loyalty, and obedience. Decision makers exercise these duties largely in the realm of making strategic decisions, evaluating, reviewing, overseeing, and approving of actions.

2. Duty of Care

Nonprofit managers are subject to the fiduciary duty of care. The duty of care, most simplified, is a duty to stay informed and exercise ordinary care and prudence in management of the organization.

a. <u>Trustees</u>

To satisfy the duty of care, trustees are called upon to exercise the care and skill that a person of ordinary prudence would exercise in dealing with the person's own property.[8] As such, a trustee is liable for simple negligence in the performance of his duties unless a different standard is provided in the trust document. The duty of care begins with the trustee assuming the duties of trustee.[9] Once the trustee assumes such role, the trustee is under a duty to administer the trust in good faith (a concept that will be discussed below) according to its terms, the applicable state's trust code, and, where not inconsistent, the duties imposed on trustees at common law.[10]

Generally, trustees have a duty to make the assets of the trust productive while properly managing, supervising and safeguarding trust funds.[11] In trusts to which the Uniform Prudent Investor Act applies, the performance of the entire portfolio should be considered rather than focusing only on individual investments when determining the productivity of the assets of the

---

[7] *See, e.g.,* Tex. BOC § 22.223.

[8] *See* SCOTT, LAW OF TRUSTS § 174.

[9] *See, e.g.,* TEX. TRUST CODE § 117.006 (providing that within a reasonable time after accepting a trusteeship or receiving trust assets, the trustee must review the trust assets and make and implement decisions related to the retention and disposition of assets to ensure the trust is in compliance with the terms of the trust and Chapter 117 of the Texas Trust Code, where applicable).

[10] *See, e.g.,* TEX. TRUST CODE § 113.051.

[11] *See, e.g., InterFirst Bank Dallas v. Risser*, 739 S.W.2d 882, 900 (Tex. App.—Texarkana 1987, no writ).

trust.[12] A trustee may delegate investment decisions if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent's scope, and periodically reviewing the agent's actions to confirm conformance with the terms of the delegation.[13]

b. Directors

With respect to nonprofit directors, the duty of care generally obligates the decision maker to act (1) in good faith, (2) with ordinary care, and (3) in a manner he or she reasonably believes to be in the best interest of the corporation.[14]

(i) Good faith

The law rarely seeks to define "good faith" in the context of fiduciaries. Broadly, the term describes "that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation."[15] In claims for legal malpractice, for example, "good faith" is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances.[16] Thus, at least in the context of legal malpractice (which bears many similarities to breach of fiduciary duty), good faith is measured objectively based on objective facts. "Good faith" can, however, be contrasted with "bad faith." One court has stated that a fiduciary acts in bad faith when the fiduciary acts out of a motive of self-gain.[17] Certainly bad faith would also include an intent to affirmatively do harm to the organization. As a result, good faith would include putting the good of the organization first and seeking to affirmatively benefit the organization.

(ii) Ordinary care

"Ordinary care" requires the director to exercise the degree of care that a person of ordinary prudence would exercise in the same or similar circumstances. It should be noted that where the director has a special expertise (e.g., accounting expertise, legal expertise, etc.), ordinary care means that degree of care that a person with such expertise would exercise in the same or similar circumstances. A director may delegate decisions (including investment decisions) if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent's scope, and periodically reviewing the agent's actions to confirm conformance with the terms of the delegation. For example, it is common for the directors of a family foundation to delegate administrative matters to employees of a family office. While a director may delegate these types of decisions or activities, she cannot delegate her oversight (i.e. governance) responsibility.

To satisfy her duty to use ordinary care, the director should be reasonably informed with respect to the decisions she is required to make. Specifically, the decision maker must understand the purposes of the organization as set forth in the organization's governing

---

[12] *See, e.g.,* TEX. TRUST CODE § 117.004.
[13] *See, e.g.,* TEX. TRUST CODE § 117.011.
[14] *See, e.g.,* Tex. BOC § 22.221(a).
[15] *See* BLACK'S LAW DICTIONARY 693 (6th ed. 1990).
[16] *See Cosgrove v. Grimes*, 774 S.W.2d 662, 665 (Tex. 1989).
[17] *See Bohatch v. Butler & Binion*, 905 S.W.2d 597, 602 (Tex. App.—Houston [14th Dist.] 1995) *aff'd* 977 S.W.2d 543 (Tex. 1998).

documents and make decisions comporting with those purposes and direction. Furthermore, the decision maker should be familiar with management of the organization, policies of the organization, and any financial data relevant to the decisions she is making. Such familiarity and knowledge requires that the director attend board meetings and actively seek the information necessary to make an informed and independent decision regarding which course of action is in the corporation's best interest. A director should be careful to personally weigh the benefits and detriments of the course of action to the corporation rather than simply voting with the majority.

In discharging the duty of care, it is common for state law to provide that a director may rely in good faith on information, opinions, reports, or statements, including financial statements or other financial data, concerning the corporation or another person that was prepared or presented by officers, employees, a committee of the board of which the director is not a member, or, in the case of religious corporations, (1) a religious authority; or (2) a minister, priest, rabbi, or other person whose position or duties in the corporation the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented.[18] While a director may rely on the counsel of advisers, the director must nevertheless exercise her own independent judgment in making decisions as to what is in the corporation's best interests. Professionals serving as decision makers, such as attorneys and CPAs, should note that the ability to rely in good faith on others as referenced above will generally not apply where the professional/decision maker is the source of the information, opinion, report, or statement.

(iii) Best interest of the corporation

Finally, decision makers must make decisions they reasonably believe to be in the best interest of the organization. Reasonableness is based on the objective facts available to the decision maker—not simply what the individual knows but what she should have known as well. Determining whether a proposed action is in the best interest of the corporation requires weighing of many factors, including the short-term interests, the long-term interests, the costs, the benefits, etc.

c. Business Judgment Rule

Decision makers of nonprofit corporations generally have the protection of the business judgment rule so long as those persons exercise their best judgment in making decisions on behalf of the organization. The business judgment rule rests on the concept that to allow a corporation to function effectively, "those having managerial responsibility must have the freedom to make in good faith the many necessary decisions quickly and finally without the impairment of facing liability for an honest error in judgment."[19] It is reasoned that the rule only applies by default to nonprofit corporations because trusts are generally not operating entities in the sense of carrying on their own programs and thus the concept does not have the same

[18] *See, e.g.,* Tex. BOC § 3.102; Tex. BOC § 22.222.

[19] *See* MARILYN E. PHELAN & ROBERT J. DESIDERIO, NONPROFIT ORGANIZATIONS LAW AND POLICY 109 (2003) (citing *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973).

relevance.[20] Of course trusts may, in fact, carry on their own programs, and in such circumstances the trust document may provide similar levels of protection for trustees.

d. Checklist

Decision makers of nonprofit entities that engage in ongoing operations should understand that their duty of care goes beyond financial or business decisions to reach all decisions made in the course and scope of their duties as directors.

The following checklist is provided to aid decision makers in satisfying the duty of care.

- All decision makers should know the following:
  - Legal form of the organization
  - Mission of the organization
  - Provisions of Articles of Incorporation/Certificate of Formation/Declaration of Trust
  - Provisions of Bylaws
  - Any policies affecting decision makers (e.g. Conflict of Interest Policy)
  - Financial Picture (budget and financials)
  - Most recent 990
  - Existence/operations of related entities
  - Where the organization is conducting activities
  - Tax status and applicable legal requirements of the organization
  - Activities being conducted by the organization
  - Management structure
  - Key employees
  - Committee Structure
  - How directors and officers are selected

- A decision maker should seek to do the following:
  - Familiarize herself with material aspects of the organization
  - Faithfully attend meetings
  - Read materials and prepare for meetings
  - Ask questions before, during, and after meetings

[20] *See, e.g., Stern v. Lucy Webb Hayes Nat'l School for Deaconesses and Missionaries*, 381 F. Supp. 1003, 1013 (D. D.C. 1974).

- Exercise independent judgment
- Rely on appropriate sources of information
- Review minutes of the board
- Seek to stay informed as to legal obligations and good governance
- With other members of the Board, develop schedules for review and approval of the strategic direction of the organization, executive compensation, legal compliance, and budget
- Keep the following information accessible in a Board Book/Director's Notebook:
  - Articles of Incorporation/Certificate of Formation/Declaration of Trust
  - Bylaws
  - Conflict of Interest Policy
  - Minutes for the previous year
  - Most recent audit/review
  - Budget and most recent financials

3. Duty of Loyalty

The second significant fiduciary duty owed by decision makers of nonprofit organizations is the duty of loyalty. The duty of loyalty requires that the decision maker act for the benefit of the organization and not for her personal benefit, i.e. the duty of loyalty requires undivided loyalty to the organization.

Under Texas law, which is consistent with the majority view, the duty of loyalty mandates that a trustee administer the trust property solely for the benefit of the beneficiaries, avoiding any transaction that would benefit the trustee to the detriment of the beneficiaries. To ensure compliance with this strict duty of loyalty, the law prohibits conflict of interest transactions even where such transactions are fair to the beneficiaries unless the trustee made full disclosure of the transaction and obtained the consent of the beneficiaries.[21] The trustee bears the burden to demonstrate full disclosure and consent. If the trustee is unable to satisfy this burden, the transaction may be set aside, regardless of its fairness to the beneficiaries. It should be noted that a loan of trust funds to the trustee or a purchase or sale by the trustee of trust property from or to (i) the trustee or an affiliate; (ii) a director, officer, or employee of the trustee or an affiliate; (iii) a relative of the trustee; or (iv) the trustee's employer, partner, or other business associate may be set aside irrespective of disclosure.[22]

[21] *See, e.g.,* TEX. TRUST CODE §§ 113.060; 117.007.
[22] *See, e.g.,* TEX. TRUST CODE §§ 113.052; 113.053.

As with the duty of care, corporate decision makers are subject to a less exacting statutory application of the duty of loyalty in comparison to a trustee. Again, the trust document can be expanded to make these rules consistent. To satisfy her duty of loyalty, a corporate decision maker must look to the best interest of the organization rather than private gain. As the Texas Supreme Court has stated, the duty of loyalty requires an "extreme measure of candor, unselfishness, and good faith."[23] The director must not usurp corporate opportunities for personal gain, must avoid engaging in interested transactions without board approval, and must maintain the organization's confidential information.

a. Corporate Opportunity

The corporate opportunity doctrine prohibits a director from usurping opportunities of the entity for personal gain. An opportunity properly belongs to the corporation where the corporation has a "legitimate interest or expectancy in and the financial resources to take advantage of" the particular opportunity.[24] How the fiduciary learns of the opportunity can be an important factor in determining whether the opportunity properly belongs to the corporation.[25]

Where the opportunity properly belongs to the entity, the fiduciary has an obligation to disclose the opportunity and offer the opportunity to the corporation.[26] The decision maker accused of usurping a corporate opportunity can raise three primary defenses (in addition to simply denying the factual basis of the claim): (1) the entity lacked the financial resources to pursue the opportunity; (2) the entity abandoned the opportunity; or (3) the opportunity constituted a different line of business than that pursued by the entity.[27] Importantly, the fiduciary bears the burden to show abandonment or lack of financial ability.

b. Interested Transactions

As referenced above, satisfying the duty of loyalty requires the decision maker to act in good faith and not allow her personal interest to prevail over the interests of the corporation. A common type of violation of the duty of loyalty is the interested transaction, broadly characterized as a contract between the corporation and a decision maker. This is typically prohibited for trustees absent a contrary provision in the trust instrument. In the corporate context, a director is "interested" if he or she (a) makes a personal profit from the transaction with the corporation; (2) buys or sells assets of the corporation; (3) transacts business in the director's capacity with a second corporation of which the director has a significant financial interest; or (4) transacts corporate business in the director's capacity with a member of his or her family. In Texas, interested transactions between corporate fiduciaries and their corporations are presumed to be unfair on the part of the director, fraudulent on the corporation, and are thus generally voidable.

Texas law, as well as the majority of states, provides a safe harbor of sorts for interested transactions similar to that found in standard conflict of interest policies. Where the material facts are disclosed and a majority of the disinterested directors, in good faith and the exercise of

---

[23] *See International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963).
[24] *See, e.g., Landon v. S&H Marketing Group, Inc.*, 82 S.W.3d, 666, 681 (Tex. App.—Eastland 2002, no pet.).
[25] *See Scruggs Mgmt. Svcs., Inc. v. Hanson*, 2006 WL 3438243 (Tex. App.—Fort Worth 2006, no petition).
[26] *See id.*
[27] *See Landon*, 82 S.W.3d at 681.

ordinary care, authorize the transaction, the transaction is not void or voidable solely because of the director's interest or the director's participation in the meeting at which the transaction is voted on.[28] Further, such a transaction will not be void or voidable if it is fair to the corporation when it is authorized, approved, or ratified by the board.[29] However, a transaction from which a corporate fiduciary derives personal profit is "subject to the closest examination and the form of the transaction will give way to the substance of what actually has been brought about."[30] Significantly, if there has been no approval after full disclosure, the transaction is presumed unfair and the director bears the burden to show fairness. Factors considered in evaluating the fairness of a transaction include "whether the fiduciary made a full disclosure, whether the consideration (if any) is adequate, and whether the beneficiary had the benefit of independent advice."[31] Of course, there may be instances in which there can be no disinterested vote, as in a situation with a family foundation and an all-family board. In such situations, it is advisable to document disclosure of the conflict, careful consideration of the transaction, and the methodology used to determine that the transaction would be fair to the corporation.

Because it is imperative that in the event an issue arises in which a decision maker has a personal interest the decision maker disclose the interest related to the decision being made and abstain from any vote, it is prudent for the organization, and beneficial to the decision makers, for the organization to adopt a conflict of interest policy requiring disclosure of material facts related to actions between the decision maker and the organization and abstention from voting by the interested decision makers. It is important to note that the Internal Revenue Code does not mandate a nonprofit corporation exempt from taxation under § 501(c)(3) to have a conflict of interest policy (with the exception of health care organizations). With that said, the IRS is pushing organizations to adopt such policies and includes a question on Form 1023 as well as Form 990 inquiring whether an organization has adopted such a policy. Additionally, the IRS has provided a suggested conflict of interest policy for charitable entities. With the heightened scrutiny on governance practices of all corporations, including nonprofit corporations, wisdom dictates at least carefully considering the formal adoption of a conflict of interest policy to provide guidance to decision makers on complying with their duty of loyalty.

If an organization chooses to adopt a policy, the policy should consider the following:

1. Identification of the class of individuals covered by the policy;

2. Definition of "actual" and "potential" conflicts of interest;

3. Articulation of the duty of disclosure of officers and directors;

4. Appropriate "trigger" mechanisms to help identify potential conflicts;

5. Annual, episodic disclosure obligations of individuals covered by the policy;

[28] *See, e.g.,* Tex. BOC § 22.230.
[29] *See id.*
[30] *See Holloway*, 368 S.W.2d at 577.
[31] *See Miller v. Miller*, 700 S.W.2d 941, 947 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).

6. Written conflicts disclosure questionnaires;

7. A process for review of disclosed potential conflicts by a committee of disinterested directors with outside counsel's input;

8. The applicability of the corporate opportunity doctrine to the board;

9. Disclosure obligations regarding outside board service of officers and directors; and

10. Disclosure obligations regarding outside business activities of senior executive leadership.

As one commentator has described it, "[t]he key features that appear in most conflicts of interest policies can be reduced to a few simple (and alliterative) ideas: disclose, discuss, decide (by disinterested directors whenever possible) and document."[32]

Certain interested transactions between directors and the nonprofit corporations which they serve may be strictly prohibited under state law. For example, loans to directors are not allowed in Texas.[33] Further, directors who vote for or assent to the making of such loans in violation of the statutory prohibition are jointly and severally liable to the corporation for the amount of such loan until the loan is fully repaid.[34]

c. <u>Confidentiality</u>

Finally, the duty of loyalty requires a decision maker to maintain confidentiality and therefore prohibits disclosure of information about the corporation's business to any third party, unless the information is public knowledge or the corporation gives permission to disclose it.

While breach of the duty of loyalty gives rise to a tort claim under state law, it may also implicate federal tax law as such breach often results in private inurement and may also constitute self-dealing or an excess benefit transaction, concepts which will be discussed more fully below.

4. Duty of Obedience

A third duty is often added – the duty of obedience.[35] The duty of obedience is the duty to remain faithful to and pursue the goals of the organization and avoid *ultra vires* acts. In practice, the duty of obedience requires the decision maker to follow the governing documents of the organization, laws applicable to the organization (including reporting and regulatory requirements), and restrictions imposed by donors. The duty of obedience thus requires that decision makers see that the corporation's purposes are adhered to and that charitable assets are not diverted to non-charitable uses. There continues to be scholarly debate regarding the duty of

---

[32] Jane C. Nober, Conflicts of Interest, Part IV, Foundation News & Commentary, Jan/Feb 2005 Vol. 46, No. 1.
[33] *See, e.g.,* Tex. BOC § 22.225.
[34] *See id.*
[35] *See, e.g.*, Johnny Rex Buckles, *How Deep are the Springs of Obedience Norms that Bind the Overseers of Charities?*, 62 Cath. U. L. Rev. 913 (2013).

obedience and whether it should be separately identified as a distinct fiduciary duty. The American Law Institute's Principles of Law of Nonprofit Organizations decline to separately identify the duty of obedience.[36] However, those Principles recognized the concepts widely understood to be concepts of obedience (e.g., following the law, fidelity to the purposes of the corporation, following gift restrictions) as applicable components of the duties of care and loyalty. Although case law is limited with respect to specific discussion of the duty of obedience, decision makers are well-advised to understand and appreciate the duty of obedience if for no other reason than because the charity regulators, charged with enforcing nonprofit director compliance with fiduciary norms, often recognize the duty.[37]

The duty of obedience is somewhat unique to the nonprofit context and particularly tax-exempt organizations. Because tax exemption rests in the first part on being organized for an appropriate tax-exempt purpose (be it charitable or social), these organizations more specifically identify their purposes in their governing documents compared to a for profit business which may be organized to conduct all lawful operations of whatever kind or nature. One court has noted the distinction stating that "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d'etre of the organization."[38] With the additional level of specificity as to purpose, the decision maker faces a more defined realm of permissible actions. That realm can be even more narrowly defined when funds are raised for specific purposes.

Because the duty of obedience requires pursuit of the mission of the organization and protection of charitable assets, it is clearly important to understand the purposes of the organization. In the context of a nonprofit corporation, the purpose is stated in the organization's governing documents and may be amplified by other documents such as testamentary documents directing the creation of the organization, the application for exempt status filed with the Internal Revenue Service or solicitations for contributions. Each of these sources should be consulted, though the basic statement of purpose in the Articles of Incorporation/Certificate of Formation/Declaration of Trust should be given primacy.

5. Standing to Bring a Complaint

While decision makers may be exposed to liability under a number of different theories and thereby exposed to claims from a number of different potential claimants, standing to complain of wrongful conduct by the fiduciary is narrow. With respect to charitable trusts, where the trust has named beneficiaries, those beneficiaries have standing to complain of the conduct of the trustees. With respect to nonprofit corporations, the organization (acting through its board of directors) may bring an action against a decision maker based on an alleged breach of the decision maker's duties. Derivative suits may be brought by a director, member, or potentially an officer as well. Finally, the State Attorney General or state charity board has

[36] *See Principles of the Law of Nonprofit Organizations*, § 300, cmt. (g)(3) (American Law Institute).
[37] *See, e.g.*, John W. Vinson, *The Charity Oversight Authority of the Texas Attorney General*, 35 St. Mary's L. J. 243, 272-73 (2004).
[38] *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999).

standing to bring such an action against the wrongdoing trustee or director as a result of that office's role as the representative of the public interest in charity.[39]

While the public is the beneficiary of the work of charitable organizations and funds held by charitable organizations are said to be held in trust for the benefit of the public, a member of the public lacks standing on such basis to bring a claim against a decision maker. Rather, the state charity official is the proper party to protect the public's interest. In very narrow circumstances, a donor may have standing to enforce the terms of his gift when the organization ignores or violates those terms.[40] Such standing requires that the donor have a *special interest* in the donated gift.[41] Generally, however, absent contractual standing created by way of a gift instrument a donor lacks standing to enforce the terms of a completed gift.

Common causes of action against fiduciaries include breach of fiduciary duty, fraud, negligence (though the parameters of this cause of action are narrowed by the business judgment rule), and conversion (along with defalcation and embezzlement). Remedies include removal from the fiduciary position, actual damages, disgorgement of benefits, imposition of a constructive trust, and in certain circumstances, exemplary damages. It should be noted that a decision maker is not responsible for actions taken prior to his/her taking office, unless the decision maker subsequently ratifies the previous action before beginning to serve. For trustees the standard is slightly different: improperly permitting the breach to continue, failing to make a reasonable effort to compel the predecessor to deliver the trust property, or failing to make a reasonable effort to redress a predecessor's breach of trust.[42]

C. OTHER BASES OF LIABILITY

Decision makers have exposure to liability in other areas as well. Of course to the extent those individuals participate in operational activities of the organization they are exposed to liability in the performance of their duties including liability related to tort claims, employment decisions, defamation claims, etc. Exposure may also arise by virtue of the individual making a defamatory statement (for example in providing a reference), agreeing to personally guarantee the debt of the corporation, personally engaging in discrimination or sexual harassment, or otherwise participating in wrongful conduct.

In many states, directors who vote for or assent to distribution of corporate assets other than in payment of debts, when the corporation is insolvent or when such distribution would render the corporation insolvent, or during liquidation without payment and discharge or making adequate provision for payment and discharge for known debts, obligations and liabilities, are jointly and severally liable to the corporation for the value of the distributed assets to the extent that such debts, obligations and liabilities are not thereafter paid or discharged.[43] Exceptions

---

[39] *See, e.g.,* TEX. PROP. CODE § 123.001, et. seq.

[40] *See, e.g., Cornyn v. Fifty-Two Members of the Schoppa Family*, 70 S.W.3d 895 (Tex. App.—Amarillo 2001, no petition).

[41] *See id.* (holding donors had a special interest where donation was brain tissue for Alzheimer's research)*; see also* GEORGE G. BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES § 411 (Rev. 2d ed. 1991).

[42] *See, e.g.,* TEX. TRUST CODE § 114.002.

[43] *See, e.g.,* Tex. BOC § 22.226.

exist where the director relied in good faith and with ordinary care on information provided by appropriate persons such as officers, professional advisers, committees of the board on which the director does not serve, or the attorney for the corporation.[44]

Trustees and directors can face penalties for failure to comply with public inspection requirements in certain circumstances. The Internal Revenue Code contains penalties applicable to control persons, such as failure to collect and withhold employment taxes and pay them over to the IRS. These types of penalties are not unique to the foundation sector. However, in addition to these common penalties, directors and trustees of private foundations can face personal liability in the form of excise taxes for certain prohibited conduct of private foundations under the Internal Revenue Code as will be more fully discussed in Part III below.

D. A NOTE ON GOVERNANCE

The concept of "good governance" has received heightened attention in the past few years in the wake of various corporate scandals in both the for-profit and non-profit worlds. Although a thorough discussion is not permitted by time and length of this paper, the reader may wish to consider recent publications created by the Nonprofit Sector and the Internal Revenue Service. The Panel on the Nonprofit Sector's Advisory Committee on Self-Regulation of the Charitable Sector has developed 29 principles of effective practices for charitable organizations. The 29 principles can be broken into four broad categories: (1) Facilitating Legal Compliance; (2) Effective Governance; (3) Strong Financial Oversight; and (4) Responsible Fundraising. The Committee recommends all charities hold these principles as aspirational goals and that large public charities (those with annual revenues of at least $1M) and large private foundations (those with assets of at least $25M) implement the principles. It should be noted that despite the number of charities signing on to these principles, others reject full-scale adoption as a one-size fits all approach in a diverse field.[45] Although governance is largely based on state law, recognizing the interplay with federal law in the charitable sector, the IRS has continued to push toward good governance, most recently through the revised Form 990. While governance deals with much more than the duties of directors and officers, the concepts do intersect. Good governance can protect against liability. Practices such as having an audit committee, a code of ethics, and a conflict of interest policy are all aspects of good governance and each contributes to liability protection for board members.

III. FEDERAL STANDARDS OF CONDUCT

A. GENERALLY

State restraints on decision makers in the performance of their duties addressed above are only half of the equation. Where the nonprofit also seeks recognition of exemption from taxation, federal tax law imposes additional constraints on decision makers. Often these restraints intersect with the fiduciary obligations discussed above. For example, the requirement that an exempt organization pursue exclusively exempt purposes implicates the duty of obedience. The prohibition on private inurement, the prohibition against self-dealing in the

---

[44] *See id.*

[45] *See*, for example, materials from the Philanthropy Roundtable.

context of private foundations, and the prohibition against excess benefit transactions in the context of public charities implicate the duty of loyalty. However, these federal restraints apply independently of the concept of breach of fiduciary duty addressed above. In other words, an act may be both a state law breach of fiduciary duty and a violation of federal tax law.

To be entitled to recognition as exempt from taxation, an organization must be organized and operated exclusively for one or more of the purposes set forth in § 501(c) of the Internal Revenue Code. This paper will focus on organizations describes in § 501(c)(3). Within this category of organizations, entities are classified as private foundations or public charities. Different standards of conduct apply depending on this latter categorization. Classification as a private foundation or public charity is distinct from choice of form discussed above. A detailed discussion of the differences between a private foundation and a public charity is beyond the scope of this paper.

B. PRIVATE INUREMENT

The private inurement doctrine applies to both private foundations and public charities. Implicit in the requirement that the organization be operated for an exempt purpose is the requirement that it not be operated for private benefit. Within the larger concept of the prohibition on private benefit is the private inurement doctrine, of particular import to the subject of federal standards of care for decision makers.

Included in the definition of an organization exempt under § 501(c)(3) is the requirement that no part of the net earnings of the organization inure to the benefit of any private shareholder or individual. This language constitutes an absolute prohibition on allowing the assets of the organization to be used for the benefit of a person having a personal and private interest in the affairs of the organization along with the ability to control the affairs of the organization. Private inurement can result in the revocation of tax-exempt status. Significant to decision makers of public charities, private inurement can also result in intermediate sanctions being assessed against the decision makers.

C. PRIVATE FOUNDATIONS: PROHIBITED TRANSACTIONS

Private foundations are organizations qualifying for exempt status under § 501(c)(3) other than traditional public charities, publicly supported public charities, supporting organizations, and public safety testing organizations. Sections 4940-4945 of the Code provide for excise taxes related to certain prohibited transactions. Included among the excise tax scheme are excise taxes against decision makers referred to under Federal tax law as foundation managers. Foundation managers are subject to imposition of excise taxes related to acts of self-dealing (§ 4941), jeopardizing investments (§ 4944), and taxable expenditures (§ 4945).

1. Self-Dealing

Section 4941 of the Code prohibits acts of self-dealing between a private foundation (both private non-operating foundations as well as private operating foundations) and persons who are disqualified with respect to the private foundation. Because there can be no self-dealing if there is no participation by a disqualified person in the transaction, the starting point for any

analysis of potential self-dealing requires defining who constitute disqualified persons with respect to the foundation.

a. Disqualified Persons

Section 4946 of the Code defines the term "disqualified person" with respect to private foundations. A disqualified person with respect to a private foundation is:

1. A substantial contributor to the foundation;[46]

2. A foundation manager, that is any officer, director, or trustee, or a person having responsibility similar to such individuals;[47]

3. An owner of more than 20% of a corporation, partnership, trust or unincorporated enterprise which is a substantial contributor to the foundation;

4. A member of the family of anyone described in (1), (2), or (3) above (a member of the family includes ancestors, decedents, and spouses, but does not include siblings); and

5. A corporation, partnership, trust, or estate in which persons listed in (1) – (4) above own more than 35% of the total combined voting power (more than 35% of the profits interest of a partnership or more than 35% of the beneficial interest of a trust).[48]

Notwithstanding the foregoing rules, for purposes of Section 4941, organizations described in Section 501(c)(3) of the Code (other than an organization described in Section 509(a)(4)—public safety organizations) are not considered disqualified persons.

b. Self-Dealing Transactions

After identifying the universe of disqualified persons with respect to a private foundation, it is necessary to understand the breadth of transactions that the Code categorizes as self-dealing. Specifically, Section 4941 provides a list of six specific acts between a disqualified person and a private foundation that constitute self-dealing:

1. Sale or exchange, or leasing, of property between a private foundation and a disqualified person;

2. Lending of money or other extension of credit between a private foundation and a disqualified person;

---

[46] Section 507(d)(2) defines substantial contributor as any person who contributes an aggregate amount in excess of $5,000 to the foundation, if his or her total contributions are more than 2% of the total contributions received by the foundation (since its inception) before the close of the taxable year of the contribution.

[47] Treas. Reg. § 53.4946-1(f).

[48] Attribution rules apply in computing ownership percentages. Treas. Reg. § 53.4946-1(d)(e).

3. Furnishing of goods, services, or facilities between a private foundation and a disqualified person;

4. Payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

5. Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

6. Agreement by a private foundation to make any payment of money or other property to a government official (as defined in Section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period.

The prohibited acts identified above apply with equal force where the transaction takes place through an intermediary, such acts being defined as indirect self-dealing. Specifically, indirect self-dealing covers transactions from the foregoing list between a disqualified person and an organization controlled by a private foundation absent certain exceptions that will be discussed below.

Treasury Regulation 53.4941(d)-1(b)(v) provides two tests for determining that an organization is "controlled" by a private foundation:

1. If the private foundation or one or more of its managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction that if a disqualified person engaged in with the private foundation, would constitute self-dealing; or

2. If a disqualified person (together with one or more persons who are disqualified persons because of their relationship) may, only by aggregating their votes or positions of authority with that of the private foundation, require the organization to engage in such transaction.

The controlled organization can be any type of entity. Furthermore, control exists even where the aggregate voting power is less than 50% if the private foundation or one or more of its disqualified persons has the right to exercise veto power over the actions of the organization relevant to any potential acts of self-dealing.[49]

A review of the rules set forth above demonstrates the draconian nature of the self-dealing rules. Virtually every transaction involving a disqualified person in a private foundation falls within the six types of self-dealing regardless of the knowledge of the self-dealer or of the foundation if the act constitutes self-dealing, regardless of whether such act is a violation of a fiduciary duty on the part of the self-dealer or other foundation managers, and regardless of whether the act is on fair terms or even beneficial to the foundation. The rules are applied

[49] Treas. Reg. § 53.4941(d)-1(b)(5).

mechanically and can lead to unexpected results. Fortunately, the Code and Regulations provide certain exceptions that serve to mollify the strict and all-encompassing nature of the rules.

c. The Exceptions

The Code sets out eight exceptions to the self-dealing rules that it calls "special rules."[50]

1. A disqualified person may transfer indebted real or personal property to a private foundation if the foundation does not assume the mortgage or other debt or if the foundation takes the property subject to a mortgage that was placed on the property by the disqualified person prior to a 10 year period ending on the date of the gift; [51]

2. A disqualified person may lend money to a private foundation so long as the loan is without interest or other charge and the proceeds of the loan are used exclusively for purposes specified in Section 501(c)(3) of the Code;

3. A disqualified person may furnish goods, services, or facilities to a private foundation so long as such furnishing is without charge and the goods, services, or facilities are used exclusively for purposes specified in Section 501(c)(3) of the Code;

4. A private foundation may furnish goods, services, or facilities to a disqualified person if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public;

5. Except in the case of a government official, a private foundation may pay compensation (and pay or reimburse expenses) to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purposes of the private foundation so long as such compensation (or payment or reimbursement) is not excessive;[52]

6. Transactions between a private foundation and a corporation which is a disqualified person pursuant to liquidation merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization are not acts of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value;

---

[50] I.R.C. § 4941(d)(2).

[51] The Code actually speaks of this in the context of what *is* an act of self-dealing—the transfer of real or personal property by a disqualified person to a private foundation where the property is subject to a mortgage or similar lien which the foundation assumes or where the property is subject to a mortgage or similar lien which a disqualified person placed in the property within the 10 year period ending on the date of the transfer. As such, the exception is derived from inverting the rule.

[52] A determination of reasonable compensation is based upon what amount would ordinarily be paid for like services by like enterprises under like circumstances. Treas. Reg. § 1.162-7(b)(iii).

7. Certain prizes, awards, scholarships, fellowship grants, and annuity or like payments payable to certain government officials are treated as exceptions to self-dealing; and

8. A disqualified person may lease space to a private foundation in a building with other unrelated tenants so long as such lease was binding on October 9, 1969 or pursuant to renewals of such lease, was not a prohibited transaction under former § 503; and has terms that reflect an arm's length transaction both with respect to the original lease as well as subsequent renewals.

In addition to these "special rules"/exceptions found in the Code, the Treasury Regulations provide for additional exceptions to indirect self-dealing.

1. Transactions between a disqualified person and an organization controlled by a private foundation or between two disqualified persons where the foundation's assets may be affected by the transaction are not indirect self-dealing if (a) the transaction arises in the normal and customary course of a retail business engaged in with the general public, (b) in the case of a transaction between a disqualified person and an organization controlled by a private foundation, the transaction is at least as favorable to the organization controlled by the foundation as an arm's length transaction with an unrelated person, and (c) the total of the amounts involved in such transaction with respect to any one of such disqualified persons in any one taxable year does not exceed $5,000.

2. The transaction is between a disqualified person and an organization controlled by a private foundation where (a) the transaction results from a business relationship established before such transaction constituted an act of self-dealing, (b) the transaction was at least as favorable to the controlled organization as an arm's length transaction with an unrelated party would be, and (c) either (i) the controlled organization could have engaged in the transaction with someone other than a disqualified person only at severe economic hardship to the controlled organization, or (ii) because of the unique nature of the product or services provided by the controlled organization, the disqualified person could not have engaged in the transaction with anyone else, or could have done so, only by incurring severe economic hardship.

3. The Regulations provide a further exception known as the "estate administration exception" which provides flexibility in avoiding self-dealing transactions during the period of administration of an estate or revocable trust if the following conditions are met: (1) the executor, administrator, or trustee must have authority to either sell the property or reallocate it to another beneficiary, or be required to sell the property by the terms of the trust or will; (2) a probate court having jurisdiction over the estate must approve the transaction; (3) the transaction must occur before the estate or trust is terminated; (4) the estate or trust must receive an amount equal to in excess of the fair market

value of its interest or expectancy in the property at the time of the transaction, taking into account the terms of any options subject to which the property is acquired by the estate or trust; and (5) the foundation must receive (a) an interest at least as liquid as the one given up, (b) an exempt function asset, or (c) an amount of money equal to that required under an option binding upon the estate or trust.

d. Penalties

Any disqualified person who engages in an act of self-dealing (direct or indirect) is assessed an excise tax of 10% of the amount involved in the transaction for each year that the transaction is uncorrected. In addition, any director or trustee (a/k/a foundation manager) who willingly participates in the act, knowing it is prohibited, is subject to a tax of 5% of the amount involved (not to exceed $20,000 for each such act) for each year that the transaction is uncorrected. If the transaction is not timely corrected, and the 10% initially assessed timely paid, the disqualified person is subject to being assessed an additional tax of 200% of the amount involved as a second tier tax. Any foundation manager who does not correct the transaction may also be subject to a second tier tax of 50% of the amount involved (up to $20,000 for each act). If more than one foundation manager is liable under this section, such persons are jointly and severally liable (again, the $20,000 per act limitation applies). A single person can be responsible for both the self-dealer tax as well as the foundation manager tax. If the self-dealing continues uncorrected, a termination tax under Section 507 of the Code is effectively a third tier tax.[53]

Foundation managers may escape liability by showing that full disclosure of the facts of the transaction was made to counsel who provided a reasoned legal opinion and that the foundation manager relied upon that opinion. It should be noted that reliance upon a reasoned legal opinion only serves to show that an act was not "knowing" or "willful," meaning such reliance only protects a foundation manager and not the self-dealer who is subject to the penalty regardless of his knowledge that the act was an act of self-dealing. The first tier tax for self-dealing cannot be abated. The second tier tax may be abated if the self-dealer and foundation managers are successful in showing that the act was due to reasonable cause and not willful neglect and has been corrected.

e. Correction

Once it has been determined that an act of self-dealing has taken place, aside from paying the first tier penalty tax, the self-dealing must be corrected. Uncorrected self-dealing leads to a second tier tax as addressed above and, if remaining uncorrected, can ultimately lead to imposition of the termination tax. To correct an act of self-dealing, the self-dealing transaction must be "undone."

Section 4941(e)(iii) provides that the term "correction" and "correct" mean, with respect to any act of self-dealing, undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. The correction required

---

[53] Under § 507, the termination tax is the greater of all tax benefits to the foundation and its contributors or all assets of the foundation.

depends upon the nature of the self-dealing transaction. For example, in a self-dealing transaction in which a transfer took place between the foundation and a disqualified person, the transaction should be rescinded. If the transaction is excess compensation, the excess compensation should be returned. Again, however, in each case, the foundation must be put in a position not worse than before the transaction.

2. Jeopardizing Investments

In addition to acts of self-dealing, foundation managers may also be subjected to personal liability for their participation in jeopardizing investments. This restriction applies to investment actions by the foundation managers and does not apply to assets received by a private foundation by gift or bequest. A private foundation must not make investments which would jeopardize the carrying out of the exempt purpose as prohibited by I.R.C. § 4944. Although no investment is a per se violation, this rule requires close scrutiny of foundation managers' standard of care. The foundation managers will be held to a "prudent investor" standard of care. In the exercise of the requisite standard of care, the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio. The determination of whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. Caution should be exercised in the consideration of speculative investments such as working interests in oil and gas, trading on margin, trading in commodity futures, purchase of "puts" and "calls" and "straddles," warrants, selling short or other high risk investments.

If a foundation makes jeopardizing investments, a tax is imposed on the foundation equal to 10% of the amount of the improperly invested assets. Additionally, each foundation manager (i.e. the trustees or directors) who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes is assessed a tax of 10% of the amount of the improper investment (not to exceed $10,000 for each such act). If the jeopardizing investment is not disposed of within the taxable period, the foundation is assessed an additional tax of 25% of the amount improperly invested and each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes is assessed an additional tax of 10% of the amount of the improper investment (not to exceed $20,000 for each such act). The taxable period begins on the date of investment and ends the earlier of (i) the date of the mailing of a deficiency; (ii) the date on which the tax is assessed; or (iii) the date on which the investment is removed from jeopardy.

3. Taxable Expenditures

A private foundation is prohibited from making taxable expenditures which are expenditures not in furtherance of the foundation's exempt purposes.[54] Taxable expenditures include payments for non-charitable purposes or to non-qualifying recipients (unless expenditure

[54] *See* I.R.C. § 4945.

responsibility is exercised), including political campaigns and lobbying and grants to individuals for travel, study, or similar purposes without IRS pre-approval of the grant processes.

The foundation is subject to a 20% tax on each taxable expenditure, and any foundation manager who willingly participates in making the distribution knowing it is a taxable expenditure, without reasonable cause, is subject to a 5% tax on such taxable expenditure (not to exceed $10,000 for each such act). If the expenditure is not corrected within the taxable period, the foundation is subject to a tax of 100% of the amount of the taxable expenditure and the foundation manager is subject to a tax of 50% of the amount of the taxable expenditure, if the foundation manager refused to correct the transaction (not to exceed $20,000 for each such act). The taxable period is the date starting when the expenditure is made and ending the earlier of the date (i) of mailing of a notice of deficiency; or (ii) the tax is assessed.

IV. PROTECTION FOR DECISION MAKERS

While exposure to liability is inevitable, such exposure can be limited through immunity, indemnification agreements, appropriate insurance coverage, and perhaps most importantly, by the decision maker knowing the restraints on her conduct and acting accordingly.

A. IMMUNITY

Limited immunity is available to decision makers under federal law and in some states.[55] Each cited statute purports to provide immunity to volunteers (including decision makers who serve as volunteers) from certain liabilities. However, application of these immunity provisions with respect to the primary issues discussed in this paper (fiduciary obligations and federal excise taxes) is tenuous at best. Each statute excludes liability arising out of duties the volunteer owes to the organization (e.g. duties of care, loyalty, and obedience). Further, neither statute provides immunity from federal excise taxes. Finally, neither statute applies to acts committed that are intentional, willfully or wantonly negligent, or done with conscious indifference or reckless disregard for the safety of others.

B. INDEMNIFICATION

State indemnification provisions provide for indemnification to directors of nonprofit corporations for costs and liabilities incurred in connection with a lawsuit filed against the decision maker due to her position as a decision maker when the organization agrees to such indemnification by including appropriate provisions in its governing documents. The statutory scheme includes both permissive as well as mandatory indemnification while also outlining when indemnification is prohibited.[56] Generally, a corporation may indemnify a decision maker when she is sued for mismanagement of corporate property if the decision maker conducted herself in good faith and reasonably believed her actions were in the corporation's best interests. When the suit is for criminal conduct, indemnification is available if the decision maker had no reasonable cause to believe her conduct was unlawful. A corporation cannot indemnify a decision maker for willful or intentional misconduct.

[55] *See, e.g.,* Tex. Civ. Prac. & Rem. Code § 84.001 et seq.; 42 U.S.C. § 14501 et seq.
[56] *See generally* Tex. BOC § 8.101.

C. Insurance

A nonprofit corporation may provide liability insurance coverage which protects its decision makers in many instances. Providing coverage allows the organization to attract volunteer decision makers who might not otherwise risk personal liability to serve in such positions. Decision makers should confirm whether insurance exists and, if so, the extent of the coverage and its exclusions.

D. Information

Finally, decision makers can help themselves by being diligent in carrying out their duties and responsibilities. Simply knowing what duties are imposed and the law related to the discharge of such duties is an important step in protecting oneself against liability. Following through in the discharge of such duties is perhaps a decision maker's strongest method of limiting her potential liability.