

Ethical Issues Arising in Service on a Nonprofit Board or for Attorneys Representing Nonprofit Clients

Marquette Law School – Eckstein Hall, Room 263

8:00 a.m., registration and coffee

8:30 a.m., program begins

10:00 a.m., program ends

I. Welcome, M-LINC and Marquette Law School's Public Service Initiatives (Karin Holmberg Werner) 8:30 to 8:35

II. Laying the Framework (Karin Holmberg Werner) 8:35 to 8:40

Many attorneys are asked at some point in their career to serve on a nonprofit board. Additionally, attorneys are frequently asked to represent nonprofit organizations as their clients. Often, such commitments give rise to ethical questions and considerations. This CLE program is intended to highlight applicable Wisconsin and federal law, as well as best practices that should guide attorneys in such situations. Numerous case examples will be explored to provide attorneys with context on how to navigate such sticky situations.

III. The Legal Context (Karin Holmberg Werner) 8:40 to 8:55

- a. Choice of entity is important.
 - i. The duties of those governing nonprofit organizations are influenced by the legal form that the organization adopts to conduct its activities.
 - ii. For example, in Wisconsin unincorporated associations are governed by Chapter 184 of the Wisconsin Statutes, whereas trusts are governed by Chapter 701 and nonprofit or nonstock corporations are governed by Chapter 181.
- b. Legal requirements vs. good governance.
 - i. Be aware of the distinction between legal requirements vs. good governance.
 - ii. Organizations must comply with all applicable federal and state laws, but governance decisions are generally matters of choice and best practice.
- c. Wisconsin Statutes (see handout for more detail)
 - i. Chapter 181 governs nonstock (i.e., nonprofit corporations)
 - ii. A board *may delegate* certain powers and be relieved to that extent from such duties and responsibilities. (181.0801)
 - iii. **Conflict of interest** – A contract is not void or voidable if disclosure and approval by those without a conflict of interest **OR** the transaction is fair and reasonable to the corporation. (181.0831)
 - iv. General **ban on loans** to directors and officers. (181.0832)
 - v. **Reliance is allowed** unless knowledge makes unwarranted. (181.0850)
 - vi. **Limited liability** of directors and officers. (181.0855)
- d. Federal Law (see handout for more detail)
 - i. Private inurement (IRC section 501(c)(3))
 - ii. Excess benefit transaction (IRC section 4958)
 - iii. Self dealing (private foundations only) (IRC section 4941)
 - iv. Federal Volunteer Protection Act of 1997 (see handout for more detail)

- e. Internal Revenue Service Promulgations
 - i. Promote good governance through disclosure
 - ii. IRS Form 990 – promoting transparency
 - iii. Conflicts of interest – be sure to adopt a conflict of interest policy
 - 1. Disclose the conflict.
 - 2. Those with a conflict should not vote.
 - 3. Document the decision and the procedure that was followed.
 - iv. Governance policies
 - 1. Consider other governance practices and policies referenced by the Form 990 (document retention and destruction, travel and other expense reimbursement, Form 990 review, corporate minutes, whistleblower, joint ventures, affiliates, etc.)
 - 2. Review the Form 990 and your organization’s activities.
 - 3. Consult with M-LINC (mlinc@marquette.edu) for more advice.
- f. Common Law
 - i. Duty of Care
 - 1. The duty of care concerns the standard of conduct applied to directors in the discharge of their duties. *See* Fishman and Schwarz, Nonprofit Organizations Cases and Materials, 2010.
 - 2. Key aspects of duty of care:
 - a. Act in good faith;
 - b. With diligence, attention and care.
 - 3. Complement of business judgment rule under corporate law.
 - 4. Focus on how these duties are exercised (i.e., did the director ask questions, attend meetings, read the materials), not the correctness of the decision (i.e., did the decision made ultimately prove to be advantageous for the nonprofit).
 - 5. Note: tension between desire to have people serve on boards without fear of liability and need for directors to exercise governance and oversight.
 - 6. Ways to exercise duty of care:
 - a. Be familiar with organization’s finances; periodically review financial controls;
 - b. Attend all board and committee meetings and actively participate;
 - c. Carefully read material prepared for meetings prior to meetings, including minutes;
 - d. Allow time to meet without management present;
 - e. Obtain minutes for any missed meetings; and
 - f. Periodically review performance of Executive Director.
 - ii. Duty of Loyalty
 - 1. Directors owe a duty of loyalty to the corporation on whose board they serve. *See* Fishman and Schwarz, Nonprofit Organizations Cases and Materials, 2010.
 - 2. They are required to act in the *best interests* of the corporation.
 - 3. Must avoid using position for an improper personal benefit.
 - 4. Key issue is whether the transaction was fair to the corporation.
 - 5. The duty of loyalty requires the director to place the interests of the

corporation above their own personal gain.

6. This duty often arises in a conflict of interest situation.

iii. Duty of Obedience

1. Directors owe a duty to carry out the purposes of the organization as expressed in the articles of incorporation. *See Fishman and Schwarz, Nonprofit Organizations Cases and Materials*, 2010.
2. They are also under a duty to comply with all laws.
3. Least litigated of duties (care, loyalty and obedience).
4. Violations of this duty may occur when failure to file tax returns as required by law, failure to register to fundraise, failure to collect and remit sales tax to the state.

IV. Case Examples (Karin Holmberg Werner and Teig Whaley-Smith) 8:55 to 9:35

a. Excess Compensation

- i. In 2008, the President of Stevens Institute of Technology in Hoboken, NJ earned a salary and bonus of \$1,089,780.
- ii. His compensation tripled from 1998 to 2008 and was more than the compensation of presidents of Harvard, Princeton and MIT.
- iii. From 1988 to 2008, he received \$1.8 million in loans at below market rates to purchase two vacation homes.
- iv. 2007 employment agreement forgave approximately half of the loans.
- v. In 2008, Stevens paid the IRS \$750,000 in penalties and unpaid taxes as a result of an IRS inquiry.
- vi. Inquiry by NJ Attorney General.
- vii. Former directors told investigators that the board was not informed about key financial information or compensation matters. (*See* 2009 articles in New York Times and Newark Star Ledger.)
- viii. Example of possible excess benefit transaction under IRC 4948 as well as failure of the board to exercise its duty of care (didn't ask enough questions about compensation and financials of nonprofit).
- ix. Also note Wisconsin Statutes general ban on loans and questions about loans in IRS Form 990.

b. Sale of Adjacent Land to Nonprofit Officer

- i. A parcel of land adjacent to a nonprofit organization's building was privately offered for sale to an individual who was the nonprofit's board president.
- ii. The president purchased the property for herself without first offering the opportunity to the nonprofit organization.
- iii. Example of violation of the duty of loyalty.
- iv. The president arguably did not act in the organization's best interests.
- v. What should the president have done?
- vi. She should have first presented to the board that the nonprofit had the opportunity to purchase the adjacent land.
- vii. She should have asked those on the board without a conflict of interest to vote on whether the nonprofit should attempt to acquire the property.
- viii. Note: she can not vote on this decision because she has a conflict of interest due to her personal interest in the property.
- ix. In fact, not only should she disclose the conflict, but she should leave the

- room to allow the others without a conflict to vote. All such procedures should be documented in the minutes of the board meeting.
- x. If the board voted that it would not pursue the property, she would then be free to purchase the property for her own use, so long as such use would not conflict with the nonprofit's interests.
- c. Rental of Nonprofit Facility at Beneficial Rates
 - i. A director of an opera company rented the opera house as a site for his daughter's wedding.
 - ii. Normally, the site was rented out for events at a charge of \$15,000 per event.
 - iii. The director only paid \$1,000, the direct costs to the opera company.
 - iv. Note: directors are expected to pay fair value for more than the de minimis use of an organization's property.
 - v. This is a violation of the duty of loyalty to the organization as the director was not acting in the opera company's best interests.
 - d. Rental of Nonprofit-Owned Property to an Employee
 - i. A nonprofit organization owns a building.
 - ii. It uses the first two floors of the building for its programs.
 - iii. The board wishes to rent out the third floor of the building as an apartment where the Executive Director will reside.
 - iv. Is this arrangement permissible?
 - v. Yes, so long as the board documents that the apartment is being rented at fair market rates. The board should research comparables and document such research in the board meeting minutes.
 - vi. What if the Executive Director was also a member of the board?
 - vii. Parties with a conflict of interest may not vote on the transaction in which they have a conflict of interest. So, the Executive Director would have to disclose the conflict, leave the room while other directors without a conflict would vote, and ensure that this procedure was documented in the meeting minutes.
 - viii. What if the Executive Director's husband was also on the board?
 - ix. He also has a conflict of interest and may not vote on the transaction. He also must disclose the conflict, leave the room for the vote and ask that the procedure be documented in the minutes.
 - e. Failure to Collect Sales Tax for Admission Fees
 - i. A local nonprofit held its annual gala for which it charged \$300 per person to attend the event.
 - ii. A band was hired and paid \$1,000 to perform at the gala.
 - iii. The nonprofit did not charge sales tax on the tickets sold for the event.
 - iv. Nor did the nonprofit remit sales tax to the Wisconsin Department of Revenue.
 - v. This constitutes a violation of the duty of obedience, as the nonprofit did not comply with the state law. Please see the Wisconsin Department of Revenue's Publication 206 at <http://www.revenue.wi.gov/pubs/pb206.pdf> for more information.

- f. Confidentiality & Use of Confidential Information
 - i. Sarbanes Oxley Requirements: Whistleblower protection, retention of documents
 - ii. Federal Public Records Rules: Even if a private nonprofit receives federal funds, it is not subject to Freedom of Information Act, 5 U.S.C. 552, and Privacy Act of 1974, 5 U.S.C. 552a. *See Boggs v. Southeastern Tidewater Opportunity Project, 1996 WL 274381 3d (1996).*
 - iii. Wisconsin Public Records Rules:
 - 1. Wis. Stats. 19.82: only applies to government or quasi-government entities
 - 2. What is Quasi Government? The five factors are: (1) other than interest income, its sole source of funds is public tax dollars, (2) it serves a public function and has no purely private function, (3) it appears in its presentation to the public that it is part of the City, (4) the City maintains a degree of control over the entity, and (5) the City has access to entity's financial information and management plan. *State v. Beaver Dam Area Development, 312 Wis. 2d 84 at 117 (2008).*
 - iv. Non-Attorney Board Director: Duty of Loyalty (see example (b) above)
 - v. Attorney Board Director:
 - SCR 20:1.8 Conflict of Interest Prohibited Transactions**
 - b)** A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these rules.
- g. Converting For Profit to Nonprofit
 - i. Wisconsin Statutes allow conversion (181.1161)
 - ii. No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to its members, trustees, officers, or other private persons
 - 1. Establishing Fair Value – Overvaluing, Problems with Debt
 - 2. Conflicts of Interest – Process
 - 3. Conflict of Interest – If all board members are related to new owners, who can vote?
 - iii. IRS Form 990 Reporting Issues
 - iv. Conversion does not exempt debt, nor liability (Wis. Stats. 181.1161(4)(a)(2), (6))
- h. Converting Nonprofit to For-Profit
 - i. Wisconsin Statutes allow conversion (181.1161), Merger (181.1101 et al.), Sale of Assets (181.1202), or dissolution (181.1401 et al.)
 - ii. No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to its members, trustees, officers, or other private persons
 - 1. Establishing Fair Value – Undervaluing
 - 2. Establishing Fair Value – Contracts & Goodwill
 - 3. Conflicts of Interest – Process
 - 4. Conflict of Interest – If all board members are related to new owners, who can vote?

iii. Attorney Board Director:

SCR 20:1.8 Conflict of Interest Prohibited Transactions

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

- (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
- (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
- (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

V. Serving as Both a Director & Legal Advisor (Teig Whaley-Smith) 9:35 to 9:50

A. The Wisconsin Standard: Disclose, Recuse, Consider the Ethics

A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

Comment 35 to SCR 20:1.7

B. Issues that may arise

1. Are you competent in the area of law requested?

SCR 20:1.1 Competence.

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

2. What is the scope of your representation?

SCR 20:1.2 Scope of representation and allocation of authority between lawyer and client

(c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

3. Are you charging for your legal advice?

SCR 20:1.5 Fees

(b) (2) If the total cost of representation to the client, including attorney's fees, is more than \$1000, the purpose and effect of any retainer or advance fee that is paid to the lawyer shall be communicated in writing.

4. Disclosure Standards: When are you a director vs. attorney?

SCR 20:1.6 Confidentiality

(b) A lawyer shall reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary to prevent the client from committing a criminal or fraud lent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm or in substantial injury to the financial interest or property of another.

5. Indemnification: When are you a director vs. attorney?

SCR 20:1.8 Conflict of Interest Prohibited Transactions

(h) A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement;

C. Let's not forget why we are here & that we have always been more than just attorneys

SCR 20:6.1 Voluntary pro bono publico service. Every lawyer has a professional responsibility to provide legal services to those unable to pay. A lawyer should aspire to render at least 50 hours of pro bono publico legal services per year. In fulfilling this responsibility the lawyer should:

(a) provide a substantial majority of the 50 hours of legal services without fee or expectation of fee to:

(1) persons of limited means or

(2) charitable, religious, civic, community, governmental and educational organizations in matters that are designed primarily to address the needs of persons of limited means;

SCR 20:2.1 Advisor. In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.

VI. Questions/Discussion

9:50 to 10:00