CORPORATE GOVERNANCE

(published Summer 2004)

For at least a year now, we have been subject to almost weekly news stories about the misfeasance and nonfeasance of corporate directors, corporate officers and other "insiders" -- to the detriment of stockholders (investors) and employees. The good news is that these misdeeds are being aggressively pursued by federal and state prosecutors. Many senior executives and directors are looking at serious jail time as well as civil lawsuits brought by stockholders and investors, claiming substantial damages on the order of millions of dollars. One of the results of the revelations of these corporate misdeeds has been a new Federal statute, "Sarbanes-Oxley," that requires greater compliance with accounting rules and greater transparency. The consensus of the legal community is that the statute does not apply to nonprofit organizations but that in light of Sarbanes-Oxley regulators and the public are going to be taking a closer look at how nonprofit boards of directors manage the affairs of the corporation. In fact, the Internal Revenue Service is already drafting new regulations impacting nonprofit accounting and reporting.

This would be a good time for nonprofit boards to review their policies and how their board manages the affairs of the corporation.

The Board of Directors as a group is responsible for the management of the corporation (RCW 24.03.095). Boards of directors act by consensus and directors, as individuals, have no authority to give management direction unless such authority is specifically delegated to the director by action of the board.

Board members of nonprofit corporations have three duties: 1) A duty of diligence; 2) A duty of loyalty; and 3) A duty of obedience.

The duty of obedience is the duty to carry out the purposes of the corporation as they are set forth in the articles of incorporation and in the by-laws. If what the corporation is actually doing does not agree with the charter purposes, one or the other must be changed.

The duty of diligence as described in the Washington Nonprofit Corporations Act, RCW 24.03, is that the director must perform his or her duties "in good faith, in a manner such director believes to be in the best interest of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances" (RCW 24.03.127). Each director is responsible for acts or omissions of the Board unless his or her dissent is recorded in the minutes. This is true even if the director was not present at the meeting in which the action was taken or should have been taken.

A good example of the consequences of passivity and failure to use the standards of care of a prudent man on the part of directors (trustees) is the case of State of Washington v. Leppaluto et.al. No.11781 (Wash. Super. Ct., Klickitat County, April 1977) in which the Attorney General of the State of Washington (then Slade Gorton) filed suit against the trustees and former director of the Maryhill Museum for mismanagement of the museum's assets. Important note: this suit was not against the museum but was against the trustees and former director as individuals. Among the charges in the complaint were:

1. The director without permission of the trustees sold assets of the museum.
2. The director did not keep proper accounts of the proceeds recovered from such sales.
3. The director and the trustees failed to maintain the collection in proper condition.
4. The director and the trustees failed to maintain the museum building in reasonable repair.
5. The trustees did not exercise adequate supervision over the director with regard to acquisitions.

6. Trustees were permitted to purchase or borrow items from the collection or to otherwise benefit from their trustee status Practices which amounted to self-dealing.

The case was settled when the museum agreed to pursue its remedies against the one individual largely responsible for the mismanagement and to the resignation and replacement of most of the trustees.

I suggest that familiarity with this case will have a salutary effect on directors and trustees in the performance of their duties.

The duty of loyalty is the duty of directors and trustees to avoid situations in which they would have an actual or apparent conflict of interest. A conflict of interest is a situation in which the trustee may secure personal gain from any transaction with the organization. Of the three duties this is the one that is most likely to draw adverse attention of the public and the regulators. It is a top issue with the IRS. It will be recalled that the IRS insists on a provision in the Articles of Incorporation of a 501(c)(3) corporation which states, "No part of the earnings of (corporation name) shall inure to the benefit of, or be distributable to its members, trustees, officers, members or other private persons." Because of the extreme sensitivity of this issue it is important that the trustees adopt a "Conflict of Interest Policy."

A trustee should never participate in discussions of any business dealing in which the trustee or an immediate family has a financial interest. That is not to say that the organization should not do business with a supplier because a trustee has a financial interest in such supplier. It is just that the trustee must not participate in any way in the decision or influence the decision to do or not to do business with such supplier. For example, Trustee A and her husband own a substantial interest in a local construction firm. The museum needs a new roof. Because of her connections with the firm, the firm offers to do the job for its direct cost only, i.e., no overhead. This will result in a substantial saving. Is the museum precluded from doing business with the construction firm because "A" is a trustee? No, the museum is not so precluded. "A" should not participate in the decision in any way. "A" should not discuss the matter with any other trustee and should not vote on the decision. In fact, "A" should not even be present in the meeting in which the matter is discussed and voted upon.

A trustee should also not acquire any museum property (administrative property or items from the collection) whether sold at private sale, in the museum store, or at auction. This would be at least an apparent conflict of interest. Staff members or volunteers should also not acquire items from the collection, however sold, since they are in a position to have knowledge of value not available the public – thus a conflict of interest.

A closing note: This is an election year. Trustees, staff, and volunteers should be reminded that a 501(c)(3) organization is prohibited from any political activity whatsoever! Political activity is any kind of endorsement or support for any candidate for public office. This includes permitting the use of facilities (either free or for a fee), endorsements, contributions, use of mailing lists, or providing a forum for any candidate for public office. A public meeting at which all candidates were given equal time to speak would not constitute an endorsement of any particular candidate. The merits or demerits of a particular candidate should not even be discussed formally or informally at any meeting of trustees or members.

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