

**Fiduciary Duties of Nonprofit Directors and Officers
in Managing Investments**

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Bernie Madoff is only the latest perpetrator whose misdeeds have caused spectacular investment losses to nonprofit organizations.¹ Concerns about nonprofit investment losses have been ongoing for many years—in the mid-1990s following the Foundation for New Era Philanthropy pyramid scheme and again in the early 2000s with the Art Institute of Chicago’s spectacular \$43 million loss in hedge fund investment vehicles that, like Madoff, refused to disclose their proprietary strategies (87% of the Art Institute’s endowment funds at the time were invested in hedge funds).² In some instances, money managers invested with Madoff without the nonprofit’s knowledge. In other instances, nonprofits knowingly invested with Madoff either directly or through feeder funds. Sometimes Madoff or the investment advisor even served on the boards of the nonprofit organizations that invested in Madoff funds.³

¹ One hundred charitable foundations lost a combined total of more than \$2 billion to Bernie Madoff and his Ponzi scheme. See National Committee for Responsive Philanthropy, *Learning from Madoff: Lessons for Foundation Boards*, available at www.ncrp.org/files/learningfrommadoff-revised.pdf.

² See Daniel Wise, *Cuomo Probes Placement of Investments With Madoff*, N.Y.L.J., Jan. 22, 2009, at 1; S. Stecklow, *Trustee’s Filing Identifies 46 Creditors That Made Money Before New Era’s Fall*, WALL ST. J., June 19, 1995; S. Stecklow, *Incredible Offer: A Big Charity Faces Tough New Questions About Its Financing*, WALL ST. J., May 15, 1995; and Christine Williamson, *Art Institute Back on Track*, PENSIONS & INVESTMENTS, June 8, 2008, available at www.pionline.com/article/20080609/PRINTSUB/573963324.

³ Alex Nussbaum, *Yeshiva’s Madoff Loss May Total \$140 Million, School Paper Says*, Bloomberg, Dec. 16, 2009, available at www.bloomberg.com/apps/news?pid=20601087&sid=aNt23xoNODbU&refer=home.

Boardroom social pressures may have discouraged board members from questioning investment decisions, especially when nonprofits were earning desperately needed high return rates. However, nonprofit organization officers and directors may be liable to the nonprofit organization if an investment strategy proves to have been fraudulent and/or highly unprofitable, if the director or officer failed to properly fulfill his or her fiduciary duties.

Historically, state attorneys general have not been inclined to examine investments made or held by nonprofit organizations, other than when politically expedient.⁴ Furthermore, courts generally have held that third parties, including donors, do not have standing to compel nonprofit directors and officers to prudently manage funds.⁵ This apparent lack of oversight gave rise to a laissez-faire attitude on the part of some nonprofit organization boards, particularly self-perpetuating boards and other non-member organizations.⁶ Seemingly, investments could fail or not with few or no consequences to the officers and directors who fell short in fulfilling their fiduciary duties of care and loyalty. An article covering the Foundation for New Era Ponzi scheme states this attitude succinctly, “[n]o heads at the university are expected to roll because of the snafu. The board of trustees approved the investment and is not likely to punish itself.”⁷ Marshall Field, the department store heir, also expressed the prevailing

⁴ Andy Savitz, *Special Report: Selling Ethics—Hershey: A Fable for Our Times*, ETHICAL CORP. MAG., Nov. 15, 2007, available at www.ethicalcorp.com/content.asp?ContentID=5523. See also Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 946-50 (2004) and *Paterson v. Paterson Gen. Hosp.*, 235 A.2d 487 (N.J. Super. Ct. 1967) (Manifold duties of Attorney General’s office necessarily make supervision sporadic).

⁵ See, e.g., *Carl J. Herzog Found. v. University of Bridgeport*, 699 A.2d 995 (Conn. 1997) and *In re: Milton Hershey Sch.*, 911 A.2d 1258 (Pa. 2006) (“Those who may bring an action for the enforcement of a charitable trust include the Attorney General, a member of the charitable organization, or someone having a special interest in the trust.”).

⁶ Some commentators have argued that non-member nonprofit organization directors should be held to a higher duty of care than nonprofit organizations that have members to police the directors’ actions. See, e.g., Thomas H. Boyd, *A Call to Reform the Duties of Directors Under State Not-For-Profit Corporation Statutes*, 72 IOWA L. REV. 725, 741-742 (1987).

⁷ See Christopher Tobler, *Charitable Investors Err With New Era*, ARK. BUS., Dec. 25, 1995, available at www.thefreelibrary.com/Charitable+investors+err+with+New+Era.-a017184854.

sentiment. When asked about the Art Institute of Chicago's massive hedge fund investment loss, he replied, "This is the risk of the game. And we lost. So what?"⁸

The prevalence of this attitude also is reflected in a Hauser Center for Nonprofit Organizations study, which found only four reported instances nationally of nonprofit boards being taken to task for failed or imprudent investments over a seven-year period.⁹ However, in light of the current calls for reform and transparency, it is unlikely that old attitudes will continue to survive.

This Member Briefing will describe the circumstances in which directors and officers may be held liable in the context of the Delaware General Corporation Law and the Uniform Prudent Management of Institutional Funds Act (UPMIFA)¹⁰ for a failed investment strategy.¹¹ Federal and state governments' efforts to reconsider the duty-of-care standards under the Uniform Prudent Investor Act and other state prudent investor laws also will be examined briefly. Investments, for purposes of this article, include only those made to earn a financial return and

⁸ Jeanne Dugan Lanthe, Thomas M. Vurton, and Carrick Mollenkamp, *Chicago Art Institute Learns Tough Lesson About Hedge Funds*, WALL ST. J., Feb. 1, 2002, at p. A1.

⁹ Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002* (Sept. 2003), available at www.austincc.edu/npo/library/documents/wrongdoings%20by%20officers%20and%20directors.pdf.

¹⁰ UPMIFA has been enacted in Alabama (ALA. CODE §§19-3C-1 *et seq.*), Arizona (ARIZ. REV. STAT. §§ 10-11801 *et seq.*), California (CAL. PROBATE CODE §§ 18501 *et seq.*), Colorado (COLO. REV. STAT. 15-1-1101 *et seq.*), Connecticut (CONN. GEN. STAT. §§ 45a-535 *et seq.*), Delaware (DEL. CODE ANN. §§ 4701 *et seq.*), District of Columbia (D.C. CODE §§ 44-1631 *et seq.*), Georgia (GA. CODE ANN. §§ 44-15-1 *et seq.*), Idaho (IDAHO CODE ANN. §§ 33-5001 *et seq.*), Indiana (IND. CODE §§30-2-12-1 *et seq.*), Iowa (IOWA CODE §§540A.101 *et seq.*), Kansas (KAN. STAT. ANN. §§ 58-3611 *et seq.*), Maryland (MD. CODE ANN., EST. & TRUSTS §§ 15-401 *et seq.*), Minnesota (MINN. STAT. §§ 309.73 *et seq.*), Montana (MONT. CODE ANN. §§ 72-30-101 *et seq.*), Nebraska (NEB. REV. STAT. §§ 58-610 *et seq.*), Nevada (NEV. REV. STAT. §§ 164.640 *et seq.*), New Hampshire (N.H. REV. STAT. ANN. §§ 292-B:1 *et seq.*), Ohio (OHIO REV. CODE ANN. §§ 1715.51 *et seq.*), Oklahoma (OKLA. STAT. tit. 60, §§ 300.11 *et seq.*), Oregon (OR. REV. STAT. §§ 128.305 *et seq.*), South Carolina (S.C. CODE ANN. §§ 34-6-10 *et seq.*), South Dakota (S.D. CODIFIED LAWS §§ 55-14A-1 *et seq.*), Tennessee (TENN. CODE ANN. §§ 35-10-201 *et seq.*), Texas (TEX. PROP. CODE §§ 163.001 *et seq.*), Utah (UTAH CODE ANN. §§ 51-8-101 *et seq.*), Virginia (VA. CODE ANN. §§ 55-268.11 *et seq.*), and West Virginia (W. VA. CODE §§ 44-6A-1 *et seq.*). UPMIFA is available at www.law.upenn.edu/bll/archives/ulc/umoifa/2006final_act.pdf.

¹¹ DEL. CODE ANN. tit. 8. (Delaware General Corporation Law). Employee retirement plan investments are, in many cases, governed by the Employee Retirement Income Security Act (ERISA), and public employee retirement system investments are subject to state-specific requirements. Review of these acts is beyond this article's scope. Healthcare facility program assets also are beyond this article's scope, but are subject in many states to specific notification and other requirements upon disposition. See e.g., CAL. CORP. CODE §§ 5920 *et seq.* and CAL. CODE REGS. tit. 11, § 999.5.

do not include those made to advance a charitable purpose (e.g., personal or real property held by a charity for direct use in its charitable activities).¹² While UPMIFA does not apply to a nonprofit's program assets, directors and officers should bear in mind that the Delaware General Corporation Law's duties of care and loyalty, as discussed below, apply generally to those assets.

While the rules applicable to nonprofit organization investments, as discussed below, are not black and white, cannot be mechanically applied, and at times can be inconsistent, officers and directors should keep the following guideposts in mind when investing funds for a nonprofit organization:

- Each investment and its risks should be well-understood and, where necessary, internal or external experts should be consulted;
- All material information reasonably available and relevant to making a decision to act or not act with respect to an investment should be reviewed;
- The investment decision-making process should be well-structured and implemented pursuant to a documented well-thought-out investment plan and strategy;
- Investment decisions should be made with reasonable care, skill, and caution in a timely manner;
- Responsibility for investment decisions should be assigned clearly to specific individuals;
- Each investment must be consistent with: (1) the organization's ability to sustain a loss; (2) the organization's temporal funding needs; (3) donor instructions and the organization's governing documents; and (4) what a reasonable person would do when considered in the context of the organization's overall diversified portfolio of investments;
- Sufficient resources must be provided for the administration of the organization's investment program, provided that investment costs are

¹² UPMIFA § 2(5)(A).

reasonable in relation to the organization's investments and the financial skills available within the organization;

- Investments should be monitored routinely for suitability, diversification, and performance;
- Delegations of investment authority also should be monitored routinely for appropriateness;
- Robust conflict-of-interest policies and procedures should be in place to address personal, financial, and professional conflicts of interest; and
- Organizations should consider establishing an investment committee composed of individuals with strong backgrounds in accounting, financial analysis, asset and liability management, and/or investment strategy.

Officer and Director Duties

Directors owe their organizations a duty of loyalty and a duty of care. The fiduciary duties of officers generally are the same as those of directors.¹³ If a director or officer violates his or her duty of loyalty or duty of care, he or she may be held liable to the nonprofit corporation. Under the Delaware General Corporation Law, the duty of loyalty essentially requires that the best interest of the corporation and its shareholders or members precedes over any of a director's personal interests.¹⁴ UPMIFA, in an effort to set aside the overly conservative investment limitations applied historically under common law to charity fiduciaries and trustees, adopts and follows the Delaware General Corporation Law regarding directors and officers' duty of loyalty and care obligations with respect to investments.¹⁵ The American Law Institute's draft

¹³ *Gantler v. Stephens*, 965 A.2d 695, 708 (Del. 2009).

¹⁴ See, e.g., *In re: Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 745 (Del. Ch. 2005), *aff'd generally sub nom. Brehm v. Eisner (In re: Walt Disney Co. Derivative Litig.)*, 906 A.2d 27, 67 (Del. 2006). See also DEL. CODE ANN. tit. 8, § 144 (which requires disclosures of conflicts of interest and abstention in some cases).

¹⁵ See UPMIFA § 3(b) Commissioners' comment, 7A U.L.A. 19 (2009).

Principles of the Law of Nonprofit Corporations provide that corporate law duties of loyalty and care are subject to the UPMIFA provisions.¹⁶ Duty of loyalty cases generally involve allegations of self-dealing, which would impact those directors with a pecuniary interest in an investment strategy, such as an individual serving as both director and investment adviser to a nonprofit.

To assure that nonprofit boards monitor duty-of-loyalty obligations, a conflict-of-interest policy for investments should be implemented that identifies when financial, personal, or professional interests of the board members, officers, or investment committee members compete with their duties to the nonprofit organization. The conflict-of-interest policy should: (1) require officers and directors to disclose any actual or possible conflict of interest; (2) provide for a comprehensive definition of a conflict of interest that includes financial, personal, or professional interests; (3) include specific policies and procedures to manage identified conflicts and potential conflicts; (4) provide procedures for addressing any conflicts of interest that may arise or be disclosed and any violations of the conflict-of-interest policy; and (5) provide for regular reviews of the conflict-of-interest policy. The Internal Revenue Service (IRS) has a model conflict of interest policy *available at* www.irs.gov/instructions/i1023/ar03.html that can be adapted to many nonprofit organizations.

The fiduciary duty of care under the Delaware General Corporation Law, which governs Delaware nonprofit corporations, generally requires that directors exercise that level of care that ordinarily careful and prudent persons would use in similar circumstances and inform themselves, prior to making a business decision, of all material information reasonably available to them.¹⁷ However, a nonprofit entity's investment decisions are subject to greater scrutiny under the UPMIFA provisions, as adopted in Delaware.¹⁸ Delaware's version of UPMIFA requires directors and officers to manage and invest an institution's funds in good

¹⁶ See American Law Institute, *Principles of The Law of Nonprofit Organizations* § 335 (Tentative Draft No. 1, Mar. 19, 2007).

¹⁷ *In re: Walt Disney Co. Derivative Litig.*, 907 A.2d at 749.

¹⁸ UPMIFA and its predecessor, the Uniform Management of Institutional Funds Act (UMIFA), have been adopted in forty-seven states. See *supra* note 10.

faith with the care an ordinarily prudent person in a like position would exercise under similar circumstances.¹⁹ This standard is similar to the Delaware General Corporation Law but recognizes that the circumstances to be considered include the fact that the entity is a charity and subsumes the “reasonable care, skill and caution” standard of the Uniform Prudent Investor Act, which generally is applicable to trusts.²⁰

Compliance with the duty of care is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not by hindsight.²¹ A standard of conduct is required; liability is not determined based upon the actual outcome or investment’s performance.²² “Courts do not demand investment infallibility, nor hold a trustee, director or officer to prescience in investment decisions.”²³ A board is not an insurer of the adequate performance of investments, so long as the investment decisions were made in a reasonable and defensible manner.²⁴ A well-thought-out, written investment plan and strategy will, in many cases, offer strong defense that investment decisions were reasonable and defensible.

UPMIFA’s prudent person standard of care considers whether a director or officer has special expertise, qualifications, or experience with respect to investments or was selected to serve in reliance upon such individual’s representation that he or she had special skills or expertise. These skills will be considered in determining whether the director or officer has satisfied the duty of care. Directors and officers must use their skills and expertise in managing and investing a charitable entity’s funds.²⁵ For example, where a trustee “considered himself to be an expert in financial matters, whose skills and experience were

¹⁹ DEL. CODE ANN. tit. 12, § 4703. See also UPMIFA § 3(b).

²⁰ See UPMIFA § 3(b) Commissioners' comment, 7A U.L.A. 19 (2009).

²¹ DEL. CODE ANN. tit. 12, § 4707 and UPMIFA § 7.

²² *In re: Barker*, 8 Misc. 3d 1012A, 801 N.Y.S.2d 778, 2005 NY Slip Op 51062U (2005) and 2005 N.Y. Misc. LEXIS 1397, at *5. See also *infra* note 24.

²³ *Matter of Chase Manhattan Bank*, 26 A.D.3d 824, 809 N.Y.S.2d 360, 2006 NY Slip Op 866 (N.Y. App. Div. 4th Dep't 2006).

²⁴ *Johnson v. Johnson*, 515 A.2d 255 (Ch.Div. 1986).

²⁵ DEL. CODE ANN. tit. 12, § 4703(c)(6) and UPMIFA § 3(b)(6).

worth at least \$17,000.00 a month,” the court held “him to a standard of conduct befitting that level of expertise.”²⁶ Under UPMIFA, to fulfill the duty of care, a charitable entity’s board or officers:

- *Must consider these factors, if relevant, in making investment decisions:*
 - General economic conditions;
 - The possible effect of inflation or deflation;
 - The expected tax consequences, if any, of the investment decisions and strategies;²⁷
 - The role each investment or action plays within the overall portfolio;
 - The expected total return from income and the appreciation of investments. The expected return on an investment must be consistent with the organization’s needs. In one reported example, a trustee’s actions caused a nonprofit formed to support “national or international amateur sports competition” to invest in a semi-professional hockey team (Memphis RiverKings) and an arena football team (Memphis Xplorers), both with a history of financial losses, for a purchase price well above that recommended by the organization’s financial and legal advisers. Tennessee alleges that these actions were to be a breach of the trustee’s fiduciary duties because

²⁶ *In re: Barker*, 8 Misc. 3d 1012A, 801 N.Y.S.2d 778, 2005 NY Slip Op 51062U (2005) and 2005 N.Y. Misc. LEXIS 1397, at *2. See also American Law Institute, *Principles of The Law of Nonprofit Organizations* § 335 illustration 4 to Comment a. (Tentative Draft No. 1, Mar. 19, 2007).

²⁷ Special focus must be paid to securities purchased with the proceeds of tax-exempt municipal bonds. Such investments generally must be purchased at a price no higher than “fair market value,” and not earn a higher yield on the investment of the bond proceeds than is paid in interest to bondholders. This prohibition is termed “yield restriction.” Federal law requires that any “positive arbitrage” that is obtained from the investment of bond proceeds at yields above the yield-restricted rate be paid to the government. Caution must be exercised that securities are not purchased at above-market rates which has the effect of reducing the yield to levels that appear to meet the yield-restricted rate. Yield-burning, as the practice was known, was popularly used in the 1990s. The practice now is prohibited and can have significant adverse tax consequences for an exempt organization and may result in liability to officers and directors. See e.g., *United States ex rel. Lissack v. Sakura Global Capital Mkts., Inc.*, 377 F.3d 145 (2d. Cir. 2004).

the investments were not in the best interest of the beneficiaries of the trust and would jeopardize the carrying out of the trust's purposes;²⁸

- Other resources of the charitable entity;
- The needs of the charitable entity and the fund to make distributions and to preserve capital; and
- An asset's special relationship or special value, if any, to the charitable purposes of the charitable entity.²⁹ The connection, however, should be reasonably substantial. The Restatement (Third) of Trusts permits "social investing" considerations to be taken into account "to the extent the charitable purposes would justify an expenditure . . . of funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the [nonprofit organization]."³⁰ A director's duty of loyalty requires directors to evaluate social investments solely in relation to the organization's charitable purposes. Consequently, investing based solely on a director's individual social views would be considered a breach of the director's duty of loyalty. However, decisions of nonprofit corporate officers and directors will be viewed under the terms of the business judgment rule and should be accorded some latitude.³¹

²⁸ Complaint, *State of Tennessee. v Robin G. Costa*, No. 04P-1430 (Davidson County Tenn. Seventh Cir. Ct. (Probate Division), Aug. 31, 2004). (The fiduciary duty issues never were addressed, as the Mississippi and Tennessee attorneys general focused on their respective efforts to retain jurisdiction over the trust's assets. The attorneys general ultimately divided the assets between the states in a settlement that largely ignored the underlying fiduciary duty issues.), available at http://charitygovernance.blogs.com/charity_governance/files/3428_001_2.pdf.

²⁹ DEL. CODE ANN. tit. 12, § 4703(c)(2)b.1 and UPMIFA § 3(e)(1).

³⁰ RESTATEMENT (THIRD) OF TRUSTS § 90, Cmt c. The Uniform Prudent Investor Act commentary provides "No form of so-called 'social investing' is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of the true beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefited by pursuing the particular social cause." Uniform Prudent Investor Act § 5, Commissioners' comment, 7B U.L.A. 34 (2006).

³¹ For a more in-depth discussion of considerations related to social investment decisions, see Thomas A. Troyer, Walter B. Slocombe and Robert A. Boisture, *Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds*, 74 GEO. L.J. 127 (1985).

- *Must seek investments with risk and return objectives reasonably suited to the organization and make management and investment decisions about an investment in the context of the charitable entity's portfolio of investments as a whole and as a part of an overall investment strategy, rather than in isolation.*³²

In at least one reported instance, a state attorney general alleged that a nonprofit organization's director breached her fiduciary duty by failing to adopt or adhere to an appropriate and/or adequate investment policy, resulting in significant churning of the investment portfolio and a continued and consistent pattern of investment losses.³³

To avoid potential liability, boards should establish an investment policy and strategy tailored to their organization.³⁴ The investment policy should describe: (1) the general investment objectives, both objective and subjective, that will best support the organization's mission; (2) the level of risk acceptable to the organization (e.g., a description of the asset quality standards such as quality ratings), the return expected by the organization, and a prohibition against inappropriate investments; (3) the nonprofit's strategy for diversifying its investment portfolio, which should include establishing general asset allocation parameters (including a stated rationale for the allocation); (4) the types of investments in which the organization is willing to participate; (5) the due diligence process used to evaluate prospective investments; (6) the procedures used for the regular review and performance evaluation of each investment; (7) the procedures used regularly to evaluate and select prospective advisers and managers; and (8) the procedures used for the regular review and evaluation of the organization's investment policies and strategies.

³² DEL. CODE ANN. tit. 12, § 4703(c)(2)b.2 and UPMIFA § 3(e)(2).

³³ See *supra* note 28.

³⁴ See Complaint, *Milgram v. The Trustees of the Stevens Inst. of Tech.*, No. HUD-C-000114-09 (Super. Ct. of N.J. Chancery Div. Sept. 17, 2009) in which the New Jersey Attorney General alleged in Count X that Stevens Institute's Board failed to develop an appropriate investment policy or strategy and failed to monitor the institutions' investments as required under the Uniform Management of Institutional Funds Act.

The policies should be developed with advice from financial and legal professionals and should be flexible enough to account for dynamic market conditions. Robust policies and procedures will reduce significantly the potential for director and officer liability and will define and clearly assign investment responsibilities to preclude liability through omission of management.

- *Must diversify the charitable organization's investments, unless the board or officers reasonably determine that, because of special circumstances, the organization's purposes are better served without diversification.*³⁵

Diversification must be determined by what is in the nonprofit organization's best interest. If a nonprofit cannot diversify without violating the terms of a donation, the nonprofit may have an obligation to seek modification of the restriction from the donor or a court if the lack of diversification creates imprudent risk.³⁶

Asset diversification is perhaps one of the most difficult areas for nonprofit organizations, particularly if the investment is tied closely to the trust of a donor, as illustrated by Hershey Trust's fight with the Pennsylvania attorney general. In December 2001, a deputy Pennsylvania attorney general conveyed to the Hershey Trust Board that the trust must diversify its investments to reduce the trust's interest in Hershey Foods below 52% of its investment holdings. Several months later, the Hershey Trust Board voted to sell its entire interest in Hershey Foods. The Hershey, PA, community erupted in opposition to the plan. The Pennsylvania attorney general, then running for governor, leapt into action and obtained an injunction to prevent the sale, arguing that the sale would cause adverse economic and social impact against the public interest, particularly on Hershey Foods employees and on the Derry Township community.³⁷ The

³⁵ DEL. CODE ANN. tit. 12, § 4703(c)(2)b.4 and UPMIFA § 3(e)(4).

³⁶ American Law Institute, *Principles of The Law of Nonprofit Organizations* § 335 Comment b.(2) (Tentative Draft No. 1, Mar. 19, 2007).

³⁷ *In re: Milton Hershey Sch. Trust (Appeal of Milton Hershey School)*, 807 A.2d 324 (Pa. Commw. Ct. 2002).

trial court acknowledged that the trustees had discretionary powers regarding investments and that a court would “not ordinarily interfere with what appears to be an act within that discretion. The [court then went on to say that the] rule [was], however, a general rule, not an absolute.”³⁸ According to the attorney general, the Hershey Trust Board could have pursued diversification by selling only a portion of its Hershey holdings, which is what he said his office had had in mind when it urged the trust to diversify.³⁹

- *Must make and carry out decisions concerning the retention or disposition of assets received or to rebalance a portfolio within a reasonable time.*⁴⁰ For example, a hospital could not leave funds not required for day-to-day operations in a non-interest-bearing account for a long period of time.⁴¹
- *May incur only costs that are appropriate and reasonable in relation to the investments, the nonprofit’s purposes, and the skills available to the nonprofit.*⁴²

The obligations under UPMIFA and the Delaware General Corporation Law are, however, only the minimal obligations of a director or officer. A director or officer’s duty of care can be increased through the terms of a donor’s gift or the entity’s governing documents.⁴³ The duties of nonprofit healthcare entity officers and directors also are being enumerated in further detail by industry-led organizations and the IRS.

For example, the Panel on the Nonprofit Sector, in its “Principles for Good Governance and Ethical Practice A Guide for Charities and Foundations,”

³⁸ *Id.*

³⁹ Andy Savitz, *Special Report: Selling Ethics – Hershey: A Fable for Our Times*, ETHICAL CORP. MAG., Nov. 15, 2007. Available at www.ethicalcorp.com/content.asp?ContentID=5523.

⁴⁰ DEL. CODE ANN. tit. 12, § 4703(c)(2)b.5. and UPMIFA § 3(e)(5).

⁴¹ *Stern v. Lucy Webb Hayes Nat’l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1010 (D.D.C. 1974). See also *Lynch v. John M. Redfield Found.*, 9 Cal. App. 3d 293, 88 Cal. Rptr. 86 (Cal. App. 2d Dist. 1970).

⁴² DEL. CODE ANN. tit. 12, § 4703(c)(1) and UPMIFA § 3(c)(1). See also Uniform Prudent Investor Act, which imposes similar standards, 7B U.L.A. 15 (2006).

⁴³ See *supra* note 15.

provides that “the board is responsible for establishing policies that govern how the [investible] funds will be invested and . . . [that] boards of organizations with sizeable reserves or endowments generally [should] select one or more independent investment managers to handle the organization’s investments. In those cases, the board or a committee of the board should monitor the outside investment manager(s) regularly.”⁴⁴ In addition, the organization’s “budget should . . . provide sufficient resources for effective administration of the organization[’s] . . . investment management.”⁴⁵ The Nonprofit Sector’s Principles Workbook further provides that a nonprofit must institute policies and procedures to ensure it manages and invests its funds responsibly, in accordance with all legal requirements.⁴⁶ The Restatement (Third) of Trusts suggests that a trustee must keep informed of rights and opportunities associated with an institution’s investments and make a deliberate judgment as to the exercise—or non-exercise—of those rights and opportunities.⁴⁷ While this obligation would appear to be common sense, in fact, many investments go unmonitored and investment income is tendered to state unclaimed property offices. For example, a search of “Memorial Hospital” in almost any state’s unclaimed property office will produce a listing of many unclaimed payments; although most are unclaimed insurance claim payments, some are investment returns.⁴⁸

Likewise, the Council on Foundations issued its Stewardship Principles and Practices for Independent Foundations in 2005. These principles require foundation boards to assess the effectiveness of investments and ensure that the foundation has a written investment policy adequate for the endowment’s size

⁴⁴ Panel on the Nonprofit Sector, *Principles for Good Governance and Ethical Practice A Guide for Charities and Foundations* § 22 (2007), available at www.nonprofithealthcare.org/resources/independent.pdf.

⁴⁵ *Id.* at § 24.

⁴⁶ Independent Sector and BoardSource, *The Principles Workbook: Steering Your Board Toward Good Governance and Ethical Practice*, Principle 22 (2009), available at www.independentsector.org/issues/accountability/principles_workbook.pdf.

⁴⁷ See RESTATEMENT (THIRD) OF TRUSTS § 90, Cmt. d.

⁴⁸ To check for funds, a free national service is available at www.missingmoney.com/Main/Search.cfm, which reflected 125 claims for “Memorial Hospitals” across the country as of September 9, 2009. The website www.unclaimed.org contains links to individual state treasurers’ websites that in some cases include additional unclaimed funds. For example, the California Controller’s Office reflected sixty-one unclaimed fund deposits for various “Memorial Hospitals”.

and the financial and investment objectives adopted by the board that is reviewed and approved by the board at regularly established intervals.⁴⁹

The IRS also has taken note of changes in the investments of nonprofit healthcare enterprises, including investments in joint ventures, for-profit entities, and complicated and sophisticated financial products or investments that require considerable financial and investment expertise. The IRS strongly encourages nonprofit healthcare enterprises with such investments to adopt written policies and procedures requiring boards to evaluate their participation in these investments and to take steps to safeguard their organization's assets and exempt status if they could be affected by the investment arrangement.⁵⁰

In addition, the IRS has suggested that a nonprofit organization's board-nominating process should reach out for candidates with expertise beneficial to a board, including expertise related to financial management and investments.⁵¹ Financial skills, according to the IRS, are among the most important qualities found on a diverse board.⁵² The IRS' position is consistent with recent findings by the National Committee for Responsive Philanthropy that nonprofit organizations with significant homogeneity among the trustees were more likely to suffer significant investment losses in the Madoff fraud.⁵³

The IRS' interest in nonprofit organizations' investments is highlighted in IRS Form 990, which asks whether the organization has adopted policies and procedures requiring the organization to evaluate its participation in joint ventures and requires disclosures regarding other investments, including financial derivatives and other financial products.⁵⁴

⁴⁹ Council on Foundations, *Stewardship Principles and Practices for Independent Foundations* (2005), available at www.cof.org/files/Documents/Stewardship%20Principles%20%20Best%20Practices%20Initiative/Independent/Independent_Principles_-_FINAL.pdf.

⁵⁰ IRS, *IRS Governance and Related Topics - 501(c)(3) Organizations* (2008), available at www.irs.gov/pub/irs-tege/governance_practices.pdf.

⁵¹ IRS, *IRS EO Determinations CPE-Governance* (2008), available at www.irs.gov/pub/irs-tege/eo_determs_governance.pdf.

⁵² *Id.*

⁵³ See *supra* note 1.

⁵⁴ See IRS Form 990 Part VI question 16b and Schedule D.

Duty to Monitor Investments

Directors and officers may be held liable not only for their investment decisions, but also for a failure to monitor current investments. In *In re: Barker*, the court found that a trustee was grossly negligent for both investing in a mutual fund holding unrated bonds and leaving the investment in place in view of the dismal market conditions.⁵⁵ However, under the Delaware General Corporation Law, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability" under the Delaware General Corporation Law.⁵⁶ For a director to be liable for failing to monitor corporate actions under the Delaware General Corporation Law, the board of directors must have utterly failed to implement any reporting or information system or controls for investments or, having implemented such a system or controls, consciously failed to monitor or oversee the corporation's investment operations, thus preventing the board from being informed of the risks or problems requiring their attention.⁵⁷ Imposition of liability for a failure to monitor is disfavored under the Delaware General Corporation Law and requires a showing that the directors knew that they were not discharging their fiduciary obligations.⁵⁸

Citigroup shareholders recently attempted to hold the board liable for losses incurred by Citigroup for its subprime mortgage investments. The plaintiffs alleged that the board failed to "make a good faith attempt to follow the procedures put in place or fail[ed] to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market."⁵⁹ The court found that although the shareholders' claims were framed as a failure-to-monitor breach of the duty of care, they essentially amounted to a claim that the

⁵⁵ *Supra* note 22.

⁵⁶ *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009) (citing *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), and *In re: Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996)).

⁵⁷ *Id.* at 240.

⁵⁸ *Lyondell Chem. Co. v. Ryan* at 243 n. 31.

⁵⁹ *In re: Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009).

directors should be liable personally because they failed to fully recognize the risk posed by subprime securities. While a failure to monitor claim has been called the most difficult type of director liability claim, when sufficiently strong red flags of wrongdoing are raised for a sufficient period of time, directors will be held liable for failing to act.⁶⁰ As a result, the court considered the Citigroup shareholders' claims under the traditional duty of care and duty of loyalty standards, thus providing the directors with the benefit of the business judgment rule. Consequently, the court focused on the board's decision-making process rather than evaluating the substantive merits of the board's decision to continue investments in subprime mortgages.⁶¹

Notwithstanding the latitude afforded for most board decisions under the Delaware General Corporation Law, the obligation to monitor investments under UPMIFA is express and requires active monitoring of investments in light of on-going market conditions and further requires officers and directors to act within a reasonable time to rebalance a portfolio.⁶²

Information Required to Be Obtained

Whether a director or officer has obtained all material information reasonably available, as required under the duty of care, generally is evaluated with a gross

⁶⁰ *In re: Caremark Int'l*, 698 A.2d at 967 (This theory of liability "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."). See also, e.g., *In re: Abbott Labs. Deriv. S'holders Litig.*, 325 F.3d 795, 799-802 (7th Cir.2003) (court found that the red flags were sufficient to raise a duty of monitoring claim against the directors where the FDA (1) conducted thirteen inspections of the company to determine whether it was in compliance with Food and Drug Administration (FDA) regulations; (2) sent four formal warning letters to the company (three of which were sent directly to the board chairman); (3) FDA implemented a "Voluntary Compliance Plan" to remedy compliance problems; (4) FDA filed a complaint for an injunction; (5) FDA ordered the company to destroy non-compliant product inventory; and (6) FDA met at least ten times with company representatives, including the board chairman), and *In re: Veeco Instruments, Inc. Sec. Litig.*, 434 F. Supp. 2d 267, 276-277 (S.D.N.Y.2006), as discussed in *In re: Intel Corp. Deriv. Litig.*, 621 F. Supp. 2d 165, 176-177 (red flags and failure-to-monitor claims were sufficient where board audit committee met twenty-seven times and failed to respond to: (1) two whistleblower reports; (2) an internal audit concluding that company violated federal laws on at least nine occasions, in a manner that jeopardized]the future viability of the company; and (3) reduction of accounting staff to only two people, the audit committee.).

⁶¹ *In re: Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

⁶² See UPMIFA § 3(e)(1).

negligence standard under the Delaware General Corporation Law.⁶³ The standard uses an objective test of reasonableness and “does not [require] the board [to] be informed of every fact. The board is responsible for considering only material facts that are reasonably available, not those that are immaterial or out of the board's reasonable reach.”⁶⁴ A director need only know “for the most part . . . what he need[s] to know, [and do] for the most part what he [is] required to do.”⁶⁵ The term "material" refers to information that is relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care.⁶⁶

Other states have adopted the American Law Institute's standard, which requires a director to be informed “to the extent the director reasonably believes to be appropriate under the circumstances.”⁶⁷ This standard is more aligned with UPMIFA, which provides that nonprofit corporate directors and officers have a mandatory affirmative duty to make a reasonable effort to verify facts relevant to the management and investment of funds and to investigate the accuracy of the information used in making investment decisions.⁶⁸ Consequently, directors of nonprofit entities have a higher duty to obtain and verify relevant information when making investment decisions and cannot, for example, rely blindly on a broker whose livelihood is based on trading commissions.⁶⁹

Statutory Reach of UPMIFA

UPMIFA not only governs the directors' and officers' actions, but also establishes the standard of care applicable to those to whom the directors or managers delegate responsibility for the investment and management of nonprofit organizational funds. Volunteer directors and officers also are governed by UPMIFA's duties of loyalty and care, as discussed above. However, state and

⁶³ See *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, No. 4446-VCL, slip op. at 19 (Del. Ch. May 12, 2009), *aff'd* 2009 Del. LEXIS 519.

⁶⁴ *Brehm*, 746 A.2d at 259.

⁶⁵ *In re: Walt Disney Co. Derivative Litig.*, 907 A.2d at 764-765.

⁶⁶ *Brehm*, 746 A.2d at 259 n. 49.

⁶⁷ American Law Institute, *Principles of Corporate Governance* § 4.01(c)(2) (1992).

⁶⁸ DEL. CODE ANN. tit. 12, § 4703(c)(2). See also UPMIFA § 3(b), and UPMIFA § 3(b) and (c)(2) Commissioners' comment, 7A U.L.A. 19 and 25-26 (2009).

⁶⁹ See, e.g., *Liss v. Smith*, 991 F. Supp. 278, 294-5 (S.D.N.Y. 1998).

federal volunteer shield statutes may reduce or eliminate liability for breaches of the duties of care and loyalty. UPMIFA does not limit the application of volunteer liability protection statutes.⁷⁰

Delaware, for example, provides that volunteers for nonprofit, tax-exempt organizations are not liable for damages resulting from any negligent act or omission performed in the course of working for the exempt organization.⁷¹ A "volunteer" is defined as any trustee, ex officio trustee, director, officer, agent, or worker who is engaged in an activity without compensation.⁷² The immunity, however, does not extend to acts or omissions constituting willful and wanton or grossly negligent conduct.⁷³ Volunteer immunity statutes vary widely among the states. In some cases, states limit or preclude immunity to compensated officers and directors.⁷⁴ Some states require insurance coverage as a predicate to immunity.⁷⁵ In other cases, immunity may be limited based upon the cause of action giving rise to the damages, the amount of insurance available, or the organization's activities or size.⁷⁶ Officers and directors, however, should be aware that most of the volunteer immunity statutes do not provide for the fronting or reimbursement of the defense costs. Consequently, the entity's articles of organization or bylaws should include provisions for the advancement of funds for the defense of such claims, to the extent permitted by the law of the state under which the entity organizes.

Judicial Review of Investment Decisions

A director's investment decision is evaluated under the Delaware General Corporation Law by ascertaining whether the director's decision process was

⁷⁰ See UPMIFA § 3 Commissioners' comment, 7A U.L.A. 17 - 21 (2009).

⁷¹ DEL. CODE ANN. tit. 10, § 8133.

⁷² DEL. CODE ANN. tit. 10, § 8133(a)(1).

⁷³ DEL. CODE ANN. tit. 10, § 8133(d).

⁷⁴ See, e.g., KAN. STAT. ANN. § 60-3601(a)(3).

⁷⁵ *Id.*

⁷⁶ See *Official Comm. of Unsecured Creditors for the Bankruptcy Estate of Boston Reg'l Med. Ctr., Inc. v. Ricks (In re: Boston Reg'l Med. Ctr., Inc.)*, 328 F. Supp. 2d 130 (D. Mass. 2004) (The court ruled that nonprofit directors have immunity except where the conduct is "intentionally designed to harm" or is grossly negligent and results in "harm to the person.") See also Federal Volunteer Protection Act of 1997, 42 U.S.C. § 14501 *et seq.* (However, there is no protection for a volunteer from liability to the nonprofit organization under the Federal Volunteer Protection Act.).

commensurate with that which an ordinarily careful and prudent person would use in a similar situation. The court will examine the rationality of the process employed and the director's good-faith consideration of matters brought before the board. Under the Delaware General Corporation Law, judicial duty of care determinations generally do not evaluate the substantive content of a board decision that led to a corporate loss.⁷⁷ A decision that may appear to be substantively wrong, "stupid," "egregious," or "irrational" after the fact will not lead to director liability under the Delaware General Corporation Law, so long as the process was either rational or employed in a good-faith effort to advance corporate interests.⁷⁸ Directors' decisions generally are not subject to substantive judicial second-guessing. Unlike the duty of care analysis under the Delaware General Corporation Law, in many cases the analysis of whether a director or officer has satisfied his or her duty of care obligations with respect to investment decisions under UPMIFA likely will be inseparable from the substance of an investment decision, particularly for those directors and officers with investment-related special skills.

Business Judgment Rule

Breaches of duty of care and duty of loyalty under both UPMIFA and the Delaware General Corporation Law also are reviewed with a presumption that directors and officers, in making a business decision, acted on an informed basis, in good faith, and in the honest belief that the action taken was in the company's best interests.⁷⁹ Under the business judgment rule, a court will presume that directors and officers acted properly and will not substitute its judgment for that of the board, if the board's decision can be attributed to any rational business purpose.⁸⁰ The business judgment presumption is a difficult burden for many plaintiffs to overcome.

⁷⁷ *In re: Walt Disney Co. Derivative Litig.*, 907 A.2d at 749-750.

⁷⁸ *Id.* at 750.

⁷⁹ *See, e.g., Gantler v. Stephens*, 965 A.2d 695, 705-6 (Del. 2009) and UPMIFA § 3 Commissioners' comment, 7A U.L.A. 17 (2009). *See also Janssen v. Best & Flanagan*, 662 N.W.2d 876, 883 (Minn. 2003) (finding that the business judgment rule is applied to nonprofit corporations in numerous states).

⁸⁰ *Brehm*, 906 A.2d at 67.

Even after the Madoff losses were exposed, the business judgment rule was cited in substance by Massachusetts Attorney General Martha Coakley as a reason not to pursue the directors and officers of the nonprofits that invested in Madoff's funds. Coakley stated that charities in Massachusetts most likely were victimized by Madoff and that the Attorney General's office would "assume that [the nonprofit organization's boards] have performed as a board with due diligence to make investments on behalf of their charities. We can't hold them responsible for anticipating that someone would engage in criminal activity, particularly someone who was as clever and convincing as" Madoff.⁸¹

Good Faith Reliance on Experts as a Defense

Most state business organization laws also recognize that directors and officers must rely on experts for matters outside their areas of competence.⁸² Under UPMIFA, the board or officers may delegate to an external agent the management and investment of funds, but not policy decisions, and then only to the extent that the delegation is prudent under the circumstances.⁸³ Directors and members of board committees generally are protected from liability if they have relied in good faith upon information, opinions, reports, or statements presented by the corporation's officers or employees, committees of the board of directors, or by others with respect to matters reasonably believed to be within their professional or expert competence, provided that the person upon whom reliance is placed has been selected with reasonable care.⁸⁴

Consequently, in many cases a director should not have liability for decisions made in reasonable reliance upon a professional advisor. Indeed, in some cases directors may be liable for not obtaining the advice of outside experts.⁸⁵ For example, a nonprofit board's failed investment decisions were found not to violate its fiduciary duties where the board relied, in part, on research provided by

⁸¹ Carrie Coolidge, *Blumenthal May Investigate Charities Ripped Off by Madoff*, Forbes, Dec. 22, 2008.

⁸² See, e.g., *In re: Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d at 132.

⁸³ DEL. CODE ANN. tit. 12, § 4705 and UPMIFA § 5.

⁸⁴ DEL. CODE ANN. tit. 8, § 141(e).

⁸⁵ See e.g., *Doyle v. Union Ins. Co.*, 202 Neb. 599, 608-13, 277 N.W.2d 36, 41-44 (1979).

the organization's analysts and "guidelines set forth by various investment strategy groups composed of senior portfolio managers, who regularly monitored the suitability of equity investments and rate securities in various categories based upon performance."⁸⁶ Therefore, in establishing strategies, directors are well-advised to obtain independent information, opinions, and reports from persons with professional or expert competence on the matters before the board and who have been selected with reasonable care.

Although it may be the better course of action, it is not necessary for an expert to make a formal or direct presentation to each director or to the board or committee in order for a director to rely on the expert.⁸⁷ However, the substance of the expert's analysis and information, opinions, reports, and statements must be relayed to the directors in order for them to rely on the independent information, opinions, and reports.⁸⁸ Moreover, "reliance is a tool for interpreting the delegate's reports, not an excuse for dispensing with such reports or ignoring such reports."⁸⁹

To prevail in director liability litigation, a plaintiff is required to show particularized facts, in contrast with mere conclusions, that: (1) the director did not in fact rely on the expert; (2) the director's reliance was not in good faith; (3) the director did not reasonably believe the expert's advice to be within the expert's professional competence; or (4) the director did not select the experts with reasonable care.⁹⁰ Alternatively, a director may face liability if it can be shown that the issue for which the director relied upon the expert was so obvious that his or her failure to detect the error was grossly negligent, regardless of the expert's advice, or that the board's decision was so unconscionable as to constitute waste or fraud.⁹¹

If a director stands on both sides of a transaction, however, the director has the burden of establishing the entire fairness of the transaction and cannot seek a

⁸⁶ *In re: Bankers Trust Co.*, 219 A.D.2d 266, 636 N.Y.S.2d 741 (N.Y. App. Div. 1st Dep't 1995).

⁸⁷ *See, e.g., Brehm*, 906 A.2d at 67 (Del. 2006).

⁸⁸ *Id.*

⁸⁹ *Stern v. Lucy Webb Hayes*, 381 F. Supp. at 1014.

⁹⁰ *Ash v. McCall*, 2000 Del. Ch. LEXIS 144 (Del. Ch. Sep. 15, 2000).

⁹¹ An exchange that is so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration. *See Brehm*, 746 A.2d at 263.

safe harbor through his or her reliance on the expert's advice.⁹² Thus, if a director is both a director and an investment adviser selling an investment product to the nonprofit, the interested director could not rely on the "advice of an expert" defense to relieve him or her of liability, even if the expert recommending their product is presumed to be independent from the interested director.⁹³

The selection of an agent and the scope and terms of the delegation of duties under UPMIFA must be made in good faith, in a manner consistent with the duty of care.⁹⁴ Care must be exercised, for example, in instructing and supervising or monitoring agents and in determining the degree and terms of the delegation.⁹⁵ The delegation must be consistent with the entity's purposes for the funds and the board and officers must exercise reasonable care, skill, and caution in instructing its agents.⁹⁶ The board and officers must periodically review the agent's actions in order to monitor the agent's performance and compliance with the delegation's scope and terms.⁹⁷ If a delegation is made consistent with the foregoing standards, the directors and officers generally will not be liable for the decisions or actions of an agent to whom a proper function was delegated.⁹⁸

The board of a nonprofit entity also may delegate investment decisions to internal agents, such as officers. Delegation to internal agents, however, is not governed by UPMIFA. Rather, internal delegation is governed by the previously discussed Delaware General Corporation Law.⁹⁹ Consequently the scope of a director's protection may be greater in the case of an internal delegation of the management and investment of funds. However, an officer's re-delegation of an investment decision to an external person again will be subject to UPMIFA duties.

⁹² A director generally is considered to be "interested" if he or she will receive a personal financial or other benefit from a transaction that is not shared equally by the stockholders.

⁹³ See, e.g., *Valeant Pharms. Int'l v. Jerney*, 921 A.2d 732 (Del. Ch. 2007).

⁹⁴ UPMIFA § 5.

⁹⁵ See RESTATEMENT (THIRD) OF TRUSTS § 90, Cmt. d.

⁹⁶ *Id.* See also UPMIFA § 5 Commissioners' comment, 7A U.L.A. 31-32 (2009).

⁹⁷ See also UPMIFA § 5 Commissioners' comment, 7A U.L.A. 31-32 (2009) and *Shriners Hosps. for Crippled Children v. Gardiner*, 733 P.2d 1110 (Ariz. 1987) (officers and directors must evaluate the delegate's advice and then participate, to some degree, in investment decisions).

⁹⁸ DEL. CODE ANN. tit. 12, § 4705(c) and UPMIFA § 5.

⁹⁹ See DEL. CODE ANN. tit. 12, § 4705(e) and UPMIFA § 5(e).

In contrast to Delaware’s standards, several other states expressly provide statutorily that nonprofit entities’ directors are exculpated from liability with respect to any action taken or not taken by an adviser who is an investment counsel or a trust company, bank, investment adviser, or investment manager to purchase, acquire or sell, transfer, or otherwise dispose of a security if the board acted in good faith and with ordinary care in selecting the advisor.¹⁰⁰

Exculpatory Charter Provisions

A nonprofit’s charter also may include a provision that waives a director’s liability for certain breaches of his or her fiduciary duties as a director.¹⁰¹ Under Delaware law, however, a director’s liability may not be eliminated or limited for: (1) any breach of the director’s duty of loyalty; (2) acts or omissions not undertaken in good faith or which involve intentional misconduct or a knowing violation of law; (3) any unlawful payment of a dividend, unlawful stock purchases, or unlawful redemptions; or (4) any transaction from which the director derived an improper personal benefit.¹⁰²

A lack of good faith sufficient to preclude exculpation from liability generally requires a finding that the director either intentionally harmed the corporation or was intentionally derelict in fulfilling the director’s duties. Where a director’s liability for corporate loss is predicated upon ignorance of liability-creating activities within the corporation, the Delaware Supreme Court has held that only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.¹⁰³ A lack of good faith also will be found if a director intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his or her duties.¹⁰⁴ An “extreme set of facts [is] required to sustain a disloyalty

¹⁰⁰ See, e.g., TEX. BUS. ORG. CODE § 22.224.

¹⁰¹ DEL. CODE ANN. tit. 8, § 102 (b)(7).

¹⁰² *Id.*

¹⁰³ See, e.g., *Lyondell Chem. Co.* 970 A.2d at 243.

¹⁰⁴ *Id.*

claim premised on the notion that disinterested directors were intentionally disregarding their duties.”¹⁰⁵

There have been no Delaware judicial decisions discussing whether the exculpation afforded directors under 8 DEL. CODE ANN. § 102 (b)(7) is available for a breach of the requirements of UPMIFA or its predecessor the Uniform Management of Institutional Funds Act (UMIFA), which was adopted in all states other than Alaska, Arizona, Pennsylvania, and South Dakota.¹⁰⁶ However, it is likely, for public policy reasons, that a director’s liability under UPMIFA would not be relieved by a charter provision enacted pursuant to 8 DEL. CODE ANN. § 102 (b)(7).¹⁰⁷

Further Federal Intervention—Expansion of Private Foundation Rules to Public Charities Discussed

At a March 17, 2009, Senate Finance Committee hearing on Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation, Senator Charles Grassley (R-IA) expressed his concern, in light of the losses incurred by charities in the Madoff scheme, that some nonprofit board members were more interested in helping their friends than furthering their charitable work. At the hearing, the former head of the New York State Attorney General’s Charities Bureau suggested that the jeopardy investment rules and self-dealing laws applicable to private foundations be strengthened and made applicable to public charities’ officers and directors.¹⁰⁸ These efforts are not new. In 2006, for example, the Panel on the Nonprofit Sector also recommended to the Senate Finance Committee that Congress increase the oversight of charitable organizations and create a federally funded program to help states establish or

¹⁰⁵ *Id.*

¹⁰⁶ South Dakota and Arizona subsequently have adopted UPMIFA. *See supra* note 10.

¹⁰⁷ *See, e.g.*, Uniform Trust Code § 1008, which provides that a term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference.

¹⁰⁸ Hearing on Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation before the S. Committee on Finance, 111th Cong. (2009) (statement of William Josephson), *available at* <http://finance.senate.gov/hearings/testimony/2009test/031709wjtest.pdf>.

increase their oversight, as current enforcement was infrequent and inconsistent.¹⁰⁹

For example, extending the self-dealing rules to public charities likely would have prevented Yeshiva University from losing \$100-140 million on investments tied to the Madoff scandal. Yeshiva University invested with Madoff while Madoff was a Yeshiva University trustee, and J. Ezra Merkin, a major Madoff feeder fund operator, also was a board member and chair of Yeshiva University's investment committee.¹¹⁰ Had the private foundation self-dealing rules applied to Yeshiva University, the Madoff investments likely could not have been made because none of the Internal Revenue Code self-dealing exceptions appear to be applicable.¹¹¹ A 5% tax of the amount involved in a self-dealing transaction is imposed under I.R.C. § 4941 on a foundation director or officer who knowingly participates in a self-dealing transaction, unless such participation was not willful or was due to reasonable cause.¹¹² If the self-dealing is not corrected, a tax equal to 50% of the amount involved is imposed under I.R.C. § 4941(b)(2). However, the penalty is limited to \$20,000 for each self-dealing act or failure to cure.¹¹³

The jeopardy investment provisions of the Internal Revenue Code largely are a restatement of the corporate duty of care under state law and UPMIFA; however, state law is subordinate and may not reduce an entity's obligations, duties, or responsibilities under the jeopardy investment rules.¹¹⁴ An investment is

¹⁰⁹ See Panel on the Nonprofit Sector, *Strengthening Transparency Governance Accountability of Charitable Organizations, a supplement to the final report to Congress and the Nonprofit Sector*, at p. 16, col 2. (2006). available at www.nonprofitpanel.org/Report/supplement/Panel_Supplement_Final.pdf.

¹¹⁰ See *supra* note 3. On April 6, 2009, New York Attorney General Cuomo filed suit against Mr. Merkin in connection with his self-dealing. Attorney General Cuomo alleged that Merkin breached his fiduciary duty by failing to disclose his self-dealing under the New York Not-For-Profit Corporation law § 717. See *Complaint, The People of the State of New York by Andrew M. Cuomo, Attorney General v. J. Ezra Merkin and Gabriel Capital Corporation*, No. 450879/2009 (Supreme Court of the State of N.Y. County of N.Y., Apr. 6, 2009), available at www.oag.state.ny.us/media_center/2009/apr/pdfs/merkin%20summons%20complaint.pdf%20-%20Adobe%20Acrobat%20Professional.pdf.

¹¹¹ See I.R.C. § 4941(d).

¹¹² 26 U.S.C. § 4941(a).

¹¹³ I.R.C. § 4941(c)(2).

¹¹⁴ See I.R.C. § 4944 and Treas. Reg. § 53.4944-1(a)(2).

considered to be a jeopardy investment under the Internal Revenue Code if foundation directors and officers, in making an investment, fail to exercise ordinary business care and prudence under the facts and circumstances prevailing when the investment was made, considering the long- and short-term financial needs of the foundation to carry out its exempt purposes.¹¹⁵

As under UPMIFA, the jeopardy investment rules require officers and directors, when reviewing an investment, to take into account: (1) the expected return (including both income and appreciation of capital); (2) the risks of rising and falling price levels; (3) the need for diversification within the investment portfolio; and (4) whether the investment of a particular amount jeopardizes the carrying out of the organization's exempt purposes.¹¹⁶ The analysis must be made on an investment-by-investment basis as well as on a portfolio-wide basis.¹¹⁷

While the jeopardy investment rules do not per se prohibit any types of investment, close scrutiny is applied when determining whether officers and directors have met the requisite standard of care and prudence when: (1) securities are purchased on margin; (2) commodity futures are traded; (3) investments are made in working interests in oil and gas wells; (4) "puts," "calls," and "straddles" are purchased; (5) warrants are purchased; and (6) the organization engages in short-selling.

A tax equal to 10% of the amount involved with respect to an act of self-dealing is imposed under Section 4944(a)(2) on a foundation manager who knowingly participates in a jeopardy investment, unless such participation was not willful or was due to reasonable cause. A person's participation in a jeopardy investment generally will not be considered "knowing" or "willful" if the officer or director, after all relevant facts are disclosed to legal counsel (including in-house counsel), relies on a reasoned written legal opinion that the particular investment would not be a jeopardy investment.¹¹⁸ If the officer or director does not cure a jeopardy

¹¹⁵ Treas. Reg. § 53.4944-1(a)(2).

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ Treas. Reg. § 53.4944-1(a)(2)(v).

investment, an additional tax of 5% is imposed on the involved officers and directors.¹¹⁹ However, the tax penalty applicable to any single jeopardy investment is limited to \$10,000, and the maximum amount for failing to cure a jeopardy investment is \$20,000.

While the self-dealing and jeopardy investment rules currently are not applicable to public charities, public charities should consider adopting the standards as they invest because the standards may become applicable to public charities in the future or be used by a court to interpret a public charity's officer's or director's duty of care under UPMIFA or the Delaware General Corporation Law.

Investment Committees Can Limit Liability

Many nonprofit boards have created investment committees to review investment transactions and the investment performance of both internal and external managers, establish investment policy and strategy, and assure that due diligence is performed before investment decisions are made.¹²⁰ If a board appoints qualified investment committee members and the committee regularly meets and reports to the board, the non-committee board members should not have liability for imprudent investments, even if the investment committee breached its duty of care, if the imprudence could not have been reasonably detected by the board.¹²¹ However, if the board is aware that the investment committee does not meet regularly or the committee does not report regularly to

¹¹⁹ I.R.C. § 4944(b)(2).

¹²⁰ The Art Institute of Chicago's Investment Committee is responsible for establishing the Institute's investment objectives and policies in partnership with external investment managers, for the oversight of all investments and compliance with investment policies that are approved by the Investment Committee and Executive Committee. The portfolio is designed to generate returns sufficient to meet obligations to beneficiaries at acceptable levels of risk. See www.artic.edu/aic/aboutus/annual_report_2008/FY08_Consolidated_Re.pdf. Examples of the form of Investment Committee Charters are available at <https://institutional.vanguard.com/iam/pdf/IAMSBCC.pdf>, www.packard.org/assets/files/about_the_foundation/how_we_operate/governance/investmest_cmte_charter_amended_031308.pdf and www.fordfound.org/pdfs/about_committee_charters_investment.pdf. A sample investment policy statement is available at <https://institutional.vanguard.com/iam/pdf/IAMIPS.pdf>.

¹²¹ See American Law Institute, *Principles of the Law of Nonprofit Organizations* § 335 illustration 2 to Comment a. (Tentative Draft No. 1, Mar. 19, 2007). See also *Midlantic Nat'l Bank v. Frank G. Thompson Found.*, 405 A.2d 866 (N.J. Supr. Ct. Ch. Div. 1979) (In respect to investments, the individuals comprising the board must participate in all decisions but may act by a majority decision and may appoint a committee to supervise the investments subject to the board's general approval).

the board, the nonprofit's board members may have liability, as they cannot reasonably assume that the committee is fulfilling its charge.¹²² For example, Sibley Hospital's board members were held liable for failing to supervise an investment committee when the board members knew the investment committee had not met for more than ten years and the board never received any reports from the investment committee.¹²³

Typically, investment committee members include individuals with strong backgrounds in accounting, financial analysis, asset and liability management, and/or investment strategy. Following its well-publicized investment losses, the Art Institute of Chicago developed a model investment committee with members recruited for their investment knowledge, especially with respect to alternative investments. The investment committee has subcommittees for private equity, real assets (including real estate), and hedge fund investments.¹²⁴

Only rarely will a board have more than one or two qualified members, much less enough to staff the entire committee. The degree of expertise required is often ill-understood by boards of directors, which tend to appoint individuals with generalized finance backgrounds to the investment committee. If an investment committee is not properly staffed, it is unlikely to satisfy the demands placed on it without access to competent outside independent professional advice.

An effective investment committee can produce a better decision-making environment, if: (1) the committee's members participate actively in decision making and have the requisite knowledge, and (2) the expectations of the investment committee are delineated clearly in its charter.¹²⁵ An effective investment committee can limit significantly officer and director liability.

¹²² See American Law Institute, *Principles of the Law of Nonprofit Organizations* § 335 illustration 3 to Comment a. (Tentative Draft No. 1, Mar. 19, 2007).

¹²³ *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1010 (D.D.C. 1974).

¹²⁴ Christine Williamson, *Art Institute Back on Track*, PENSIONS & INVESTMENTS, June 8, 2008, available at www.pionline.com/article/20080609/PRINTSUB/573963324.

¹²⁵ Sample Investment Committee and committee member checklists are available at <https://institutional.vanguard.com/iam/pdf/IAMNPTC.pdf> and <https://institutional.vanguard.com/iam/pdf/IAMMCL.pdf>.

Duty of Agents—Employer-Employee Agency Relationship

At least one Delaware court has observed that employees, including officers,¹²⁶ will be held to the investment standards set forth in Section 425 of the Restatement (Second) of Agency.¹²⁷ The Restatement (Second) required agents to invest their principal's funds promptly and not allow the funds to remain idle, and to invest only in securities that a prudent investor would purchase for his own account, considering both the principal's safety expectations for the principal and income and the principal's means and purposes. The agent's investment duties are similar to those of a trustee under a trust, except as modified by the principal's direction and control.¹²⁸ The Restatement's commentary provided that an agent normally would be expected to invest in a diversified portfolio and would not invest a "large portion" of the principal's funds in speculative investments.¹²⁹ Likewise, under the Restatement (Second), agents with investment management duties had a duty to monitor investments and appropriately adjust the portfolio.¹³⁰

The current Restatement (Third) of Agency, however, does not address specifically the duties of agents with respect to investments. The current Restatement addresses agent's duties with respect to investments more generally in Section 8.08, which provides that an agent must act with the care, competence, and diligence normally exercised by agents in similar circumstances.¹³¹ The Restatement further provides that where an agent possesses special skills or knowledge or claims to possess special skills or knowledge, the agent is obliged to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.¹³²

It is unclear what impact these agency duties will have on a court's interpretation of nonprofit officers' and directors' investment duties. Few reported cases have

¹²⁶ An organization's employees are its agents. See RESTATEMENT (THIRD) OF AGENCY § 1.01, Cmt. c.

¹²⁷ See *Lazard Debt Recovery GP, LLC v. Weinstock*, 864 A.2d 955 (Del. Ch. 2004).

¹²⁸ RESTATEMENT (SECOND) OF AGENCY § 425, Cmt. a.

¹²⁹ RESTATEMENT (SECOND) OF AGENCY § 425, Cmt. b.

¹³⁰ RESTATEMENT (SECOND) OF AGENCY § 425.

¹³¹ RESTATEMENT (THIRD) OF AGENCY § 8.08.

¹³² *Id.*

cited Section 425 of the Restatement (Second) of Agency, and the more general nature of Section 8.08 of the Restatement (Third) of Agency suggests that it is less likely to be invoked with respect to officer and director investment decisions, especially in light of the more detailed requirements of UPMIFA and UMIFA. Nonetheless, because these common law provisions may require greater care by nonprofit officers and directors related to their investment actions, officers and directors should consider assuring that their investment actions are consistent.

Conclusion

Director and officer liability is not determined by the performance of any one investment or even the performance of an entire portfolio, but rather on whether the directors and officers followed prudent investment practices and procedures. Nonprofit corporations should assure that their officers and directors manage and invest funds responsibly, in accordance with all legal requirements, through a formally documented decision-making and investment-monitoring process.¹³³ The process should include the establishment of written investment policy statements.

Whenever a nonprofit invests in any unfamiliar or alternative investments, the investment committee should assure that the investments are understood and appropriately valued and should strongly consider utilizing outside experts. When experts are being selected, the board should review carefully each outside expert's experience, past performance, philosophy, and entire set of qualifications.

Michael DeLucia, director of Charitable Trusts and senior assistant attorney general at the New Hampshire Attorney General's Office, summed up the nonprofit conundrum: "[i]n the charitable sector, there tends to be more trust and less scrutiny [P]eople appear to be more trusting and have less internal controls and oversight. That is a weakness. [Nonetheless, the] board has a

¹³³ See Complaint, *Milgram v. The Trustees of the Stevens Inst. of Tech.*, No. HUD-C-000114-09 (Super. Ct. of N.J. Chancery Div. Sept. 17, 2009).

fiduciary duty to protect their charitable assets [and] if they do not take the steps to prevent fraud, then they are in breach of their fiduciary duties.”¹³⁴

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¹³⁴ Carrie Coolidge, *Blumenthal May Investigate Charities Ripped Off by Madoff*, Forbes, Dec. 22, 2008.