INTRODUCTION

This article summarizes the fiduciary duties of directors and officers of Colorado nonprofit organizations. It is intended as a guide for all nonprofits, although some provisions and statements will be noted in the text as applying specifically to charitable organizations that are tax-exempt under § 501(c)(3) of the Internal Revenue Code.

Nonprofit corporations are created under state law (“the Colorado Revised Nonprofit Corporation Act”), and for the most part, it is state law that determines how they may (or must) be governed. In addition to what is required by state law, a nonprofit’s articles of incorporation, bylaws and board policies may provide more specific policies and procedures to govern the organization’s activities.

A board of directors is responsible for actually governing the organization within the constraints of the law and the governing documents. Crucially, the board is also responsible for protecting the organization’s charitable assets. Governing a nonprofit organization requires the board of directors to manage its officers and ensure that the organization operates in furtherance of its charitable and tax-exempt purposes. But, overseeing the organization does not include day-to-day management of the organization’s employees. While it’s perfectly acceptable for the board to delegate daily management decisions to an executive team, it’s essential that it actively oversees executive management and sets organizational policies to ensure that the organization remains true to its mission and operates with integrity.

Because the board plays such a central role in governing a nonprofit corporation, its directors and officers need to understand their roles and their obligations as they perform their duties. The material in this training module is intended to help you understand your responsibilities as a director or officer of a Colorado nonprofit corporation.

Fiduciary Duties
When you agree to serve on a board of directors, you enter into a fiduciary relationship with the nonprofit and accept certain legal duties and obligations. In the Restatement (Third) of the Law of Trustees, a fiduciary relationship is described as a situation in which one person has an affirmative
duty to act for the benefit of other persons in all matters falling within the scope of the relationship between the parties.\

Fiduciary duties are intended to ensure a high degree of care and complete loyalty to the nonprofit in order to protect charitable assets that are held for the benefit of the general public rather than particular individuals. Under common law, they are described as the duty of care, the duty of loyalty, and the duty of obedience. These terms are somewhat vague by design, which allows courts and regulators some flexibility in cases where a breach of fiduciary duty is alleged. Unfortunately, this vagueness means that the directors and officers charged with fulfilling their fiduciary duties do not always fully understand what they entail, so this training will introduce you to some key definitions and concepts and give you some tools to assure yourself you are fulfilling these duties to the organization. So, we’ll begin by defining these duties in simple terms.

The **duty of loyalty** means putting the organization’s interests ahead of any private interests. In other words, the director, or a party related to a director, may not profit to the detriment of the organization.\

The **duty of care** requires directors to devote the necessary amount of time and attention to the affairs of the nonprofit so they will be able to make reasonable and informed decisions. Or as one author put it, “a director has the duty or obligation to be informed, ask questions, participate in deliberations, and exercise judgment.”

Finally, the **duty of obedience** means a duty to carry out the purposes of the organization and to obey all applicable local, state, and federal laws. The purposes of the organization are defined in the articles of incorporation, its bylaws, mission statements, and any other governing documents. Sometimes this duty is expressed as a separate and distinct duty, and sometimes it is treated as encompassed under the duties of care and/or loyalty.

A frequently cited article by former SEC Commissioner Harvey J. Goldschmidt describes the differences between the duty of loyalty and the duty of care this way:

> Allegations of neglect, mismanagement, and improper (but disinterested) decision-making are dealt with under the **duty of care** and the business judgment rule. Fraud, self-dealing, misappropriation of corporate opportunities, improper diversion of corporate assets, and similar matters involving conflicts between a director’s or officer’s interest and the corporation’s welfare are considered under **duty of loyalty** statute and case law.

All of these concepts originated in case law, but they have also evolved and been incorporated, at least to some extent, into the statutory rules governing nonprofit corporations. In Colorado, those statutory rules are found in the Colorado Revised Nonprofit Corporation Act (“CRNCA”). The **duty of care** has been incorporated fully into CRNCA. The **duty of loyalty** continues to be based primarily on case law, though aspects of the duty have been incorporated in the statutory rules on conflicting interest transactions. In order words, both statutory rules and case law are important in defining the duties of care and loyalty of a director or officer of a nonprofit corporation.

The **duty of obedience** isn’t expressly addressed in the Colorado statutes or case law. Nonetheless, directors and officers should take seriously the need to carry out the organization’s purpose and obey applicable law, as failure to do so could implicate the duties of care and/or loyalty.

**Nonprofit Corporate Directors Are Not Trustees**
Colorado law holds trustees of a trust to a higher fiduciary standard of care due to their presumed level of professional expertise than the standard which applies to corporate directors. Under the CRNCA, directors of nonprofit corporations are not considered trustees, even if they are called trustees, and thus they are held to a standard that is much closer to that of a corporate director. viii

STANDARDS OF CONDUCT FOR DIRECTORS AND OFFICERS

The vast majority of charities are organized as nonprofit corporations, so we will focus on the duty of care and the duty of loyalty as they apply to directors and officers of nonprofit corporations. As mentioned above, these duties have been incorporated, at least in part, under the Colorado Revised Nonprofit Corporation Act (“CRNCA”). ix Both duties are similar to the duties that apply to directors and officers of for-profit corporations. However, they differ in one significant way -- a nonprofit director or officer is concerned primarily with maximizing the efficacy with which the organization performs its charitable mission, while a for-profit director is concerned primarily with the long-term maximization of profit. It’s not clear whether the courts recognize this distinction, but it means nonprofit directors and officers may very well be making more complex decisions than for-profit directors and officers, because they need to factor in both economic matters and the charity’s mission.

Duty of Care
The standards of conduct for nonprofit directors and officers under CRNCA require that they discharge their duties to the nonprofit corporation:

1. in good faith;
2. with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
3. in a manner the director or officer reasonably believes to be in the best interests of the nonprofit corporation.

Good Faith
The first part of the standards, “good faith,” requires honesty of intention, openness, and fair dealing. If a suit was brought claiming breach of fiduciary duty, and if a court were to evaluate whether a director or officer acted in good faith, it would consider his state of mind and try to determine whether the director or officer was acting honestly and with faithfulness to his duties or obligations, or whether he was trying to take advantage of the corporation. x

Ordinary Prudent Person
The second part of the standards requires directors and officers to act with the care of an ordinarily prudent person, which means they need to balance the potential risks and rewards when making their decisions. They do not have to guarantee results, and they are allowed to make errors of judgment or mistakes, as long as they act with common sense and use informed judgment. In order to do so, directors and officers need to stay adequately informed about the nonprofit’s affairs, so they understand when issues need their attention. xi

Like Position
This concept requires a court to consider the conduct of a director or officer in the context of his own organization’s goals and resources, as opposed to those of a hypothetical entity. Different goals and resources among nonprofit corporations will change the way a director or officer balances
potential risks and rewards. In addition, this provision requires courts to factor in the differences between for-profit and nonprofit organizations, e.g. pursuit of the public good vs. the profit motive.

Similar Circumstances
The concept of “similar circumstances” allows the court to take into account the background, qualifications and experience of an individual director or officer and the role he plays in the nonprofit. The courts can also take into account the reason for his or her election, such as his fundraising skills or marketing experience, in deciding whether he fulfilled his duty of care to the nonprofit. This does not mean, however, that a director or officer can be a mere figurehead. Regardless of the reason he is there, a director or officer cannot abdicate his responsibilities and duties.

In the Best Interests of the Nonprofit
This element of the standards of conduct requires directors and officers to subjectively believe they are acting in the best interests of the nonprofit corporation, as long as that belief was objectively reasonable.

The Business Judgment Rule
The liability for a director for breach of the fiduciary duty of care may to some extent depend on whether a court applies the so-called business judgment rule in the case -- a doctrine that also originated in case law. If a court applies the business judgment rule, it means it will merely examine whether a director had a rational belief that his decision was in the nonprofit’s best interests. The business judgment rule can only be invoked, however, for conscious decisions made in good faith, without divided loyalty or a conflict or interest, and on a reasonably informed basis. Essentially, the rule is intended to protect nonprofit directors and officers from subsequent review of unsuccessful decisions and to encourage them to act prudently yet decisively in support of the mission of the corporation.

If the business judgment rule does not apply for whatever reason (e.g., the director had a conflict of interest, did not act in good faith, or was not reasonably informed), the court will examine whether a director had a reasonable belief that his decision was in the corporation’s best interests. In legal parlance, this boils down to the rational review vs. the reasonable review, and the former is viewed as more lenient, allowing a director significantly more discretion in making decisions. If a court were to apply the more lenient standard for deciding whether a nonprofit director exercised the duty of care appropriately, it is highly unlikely that he would be found liable for breach of fiduciary duty.

Many states, including Colorado, also have adopted statutory limitations on liability that go beyond the protection of the business judgment rule. This is partly in response to concerns about establishing that a director acted on an informed basis, and in recognition of the difficulty in attracting qualified individuals to serve as voluntary directors of nonprofit corporations. In Colorado, a nonprofit can eliminate or limit the personal liability of a director (but not an officer) to the nonprofit corporation or to its members for monetary damages for breach of the duty of care, by including a provision to that effect within its articles of incorporation. However, no limitation on liability will apply to breaches of the duty of loyalty; actions not in good faith or that involve intentional misconduct or a knowing violation of law; approval of an illegal distribution or a loan to an officer or director; or participation in a transaction that results in an improper personal benefit to the director.

Upholding the Duty of Care
Here are a few things nonprofit directors and officers can do to assure themselves that they are upholding their fiduciary duty of care to the organization:
Throughout the Year
- Learn all about the nonprofit’s purpose, activities, and plans.
- Know the procedures listed in the organization’s articles of incorporation and its bylaws.
- Request expert advice if a decision requires information and judgment that is outside the board’s experience and expertise.
- Do not simply “rubber stamp” management requests, but instead develop the habit of requesting whatever information you need to make a good decision.

For Board Meetings
- Attend all board meetings.
- Be prepared for board meetings by reading the minutes from the previous meeting, the agenda, and any additional information provided.
- Read committee reports.

Accounting and Financials
- Require annual budgets and frequent financial reports.
- Ensure that proper accounting systems and internal controls are in place to prevent fraud and embezzlement in your organization. For example, does the organization do a background check on new employees? Does the organization require two signatures on each check that is issued? Does the board’s insurance policy cover employee theft?
- Review and approve budgets prepared by staff.
- Review financial reports.
- Consider hiring a CPA to audit or review the organization’s annual financial statement. If you do, review the audit reports and read the management letter prepared by the independent auditor.

Good Governance Practices
- Insist on compliance with all applicable laws and review the organization’s regulatory filings before they are filed. This includes state registration to solicit contributions, review of the IRS Form 990 or 990-PF, and payment of any wage withholding or employment taxes.
- Avoid making illegal distributions of the organization’s assets. Distributions by nonprofits are generally forbidden, with only a few exceptions, such as paying reasonable compensation to members, directors, or officers for services rendered.
- Have a conflict of interest policy for staff, volunteers, and the board, and disclose any conflicts of interest to the board and any voting members right awayxxii.
- Be alert for “founder’s syndrome,” where a strong-willed founder makes all the decisions and takes care of all the bookkeeping while providing very little in the way of transparency and accountability.
- The organization should foster an atmosphere that encourages employees to come forward with problems. Consider putting a whistleblower policy into place.

These are straightforward measures you can take to assure that you are successful in meeting your fiduciary duties. As long as you are aware of these affirmative duties and take basic measures to ensure you are performing them, you should not find it difficult to avoid trouble while serving as a director or officer for a Colorado nonprofit.
Duty of Loyalty and Conflicting Interest Transactions

Conflicts of interest, which implicate the fiduciary duty of loyalty, easily can arise for directors and officers in a variety of ways, such as approval of an officer’s compensation or engaging a director’s company to perform services. Under CRNCA, a conflict of interest transaction means a contract, transaction, or other financial relationship between the nonprofit and one of its directors, or between the nonprofit and someone related to a director (“related party”), or between the nonprofit and another business for which the director is a director or officer or has a financial interest.

A related party includes a spouse, a descendent, an ancestor, a sibling, the spouse or descendent of a sibling, or an estate or trust in which the director or a related party has a beneficial interest. In addition, a related party includes any entities for which a related party serves as an officer or director, or in which a related party has a financial interest.

The mere existence of a conflict is not prohibited, and CRNCA provides that a conflict of interest transaction is not voidable if (i) there is disclosure of material facts as to the conflict of interest to the board of directors or any board committee delegated authority over the matter (or voting members, if applicable), and the transaction is approved by the affirmative vote of a majority of disinterested directors (or voting members, if applicable), or (ii) the transaction is fair to the nonprofit corporation.

Nonprofit corporations should take this a step further and develop a conflict of interest policy that clarifies that directors and officers have an affirmative duty to disclose conflicts of interest on an ongoing basis, and that lays out the process for approving and documenting such transactions. Essentially, the following steps should apply:

- The material facts regarding the individual’s relationship or interest in the matter should be fully explained to the board of directors (or to any members entitled to vote on the transaction);
- While the individual with the conflict can make a presentation and respond to questions, he or she should leave during deliberation, debate and voting, and should not attempt to exert personal influence regarding the matter;
- A majority of disinterested board members (or the members entitled to vote) should authorize the conflicting interest transaction by a vote; and
- Information related to the vote should be recorded in the meeting minutes, including the name of the individual with the conflict, the disclosure of material facts, the fact that the individual was not present during deliberation and voting, the names of board members present for deliberation and voting, and that the nonprofit decided to enter into the transaction for its own benefit.

Separate and apart from Colorado law on conflicts of interest, a nonprofit will need to comply with additional federal tax law restrictions (and any restrictions of any other applicable laws or regulations, e.g., federal grant guidelines). For 501(c)(3) public charities, the tax code can impose penalties called intermediate sanctions on so-called “excess benefit transactions” with insiders or related persons (e.g., excessive compensation to an officer, or a “sweetheart” sale to a director’s company), and in more severe cases tax-exempt status can be revoked. In addition, 501(c)(3) private foundations need to comply with the strict self-dealing rules, which prohibit many transactions between the foundation and its insiders or related persons.
Also, directors and officers should remember that the duty of loyalty can be implicated by transactions not specifically called out in the statute (e.g., where an officer or director usurps a corporate opportunity or benefits through specialized knowledge received in the capacity of officer or director).

**Limited Liability**

CRNCA contains a number of provisions that limit the potential liability of directors and officers of nonprofit corporations to the corporation, its members and others. As discussed above in the context of the business judgment rule, CRNCA permits a nonprofit corporation to eliminate or limit the personal liability of a director to the corporation or to its members for monetary damages for breach of the fiduciary duty of care, in limited circumstances, if such a provision is included in the nonprofit’s articles of incorporation. In addition, CRNCA provides:

- a director or officer is not liable as such to the corporation or its members for any action or omission made as a director or officer, if the individual complied with the standards of conduct established in CRNCA;
- a director or officer will not have any fiduciary duty to a creditor of the nonprofit arising only from the status as a creditor;
- a director or officer is not personally liable for any injury to a person or property arising out of a tort committed by an employee, unless the director or officer was personally involved in the situation giving rise to the litigation or unless the director or officer committed a criminal offense in connection with the situation.

Finally, directors of nonprofit corporations will not be liable for actions or omissions made in the performance of duties as a board member except for wanton and willful acts or omissions. Note that this provision is not within CRNCA, and applies more broadly to nonprofit organizations that aren’t in the corporate form.

**Reliance**

Fortunately, you have some protection and guidance regarding what it means to discharge your duties with the care an ordinarily prudent person in a like position would exercise in similar circumstances. CRNCA states that a director or officer is entitled to rely on information presented by an officer or employee of the nonprofit corporation whom the director or officer reasonably believes to be reliable and competent. In addition, directors and officers can rely on information presented by (i) legal counsel, public accountants, or other people who are functioning within their area of professional expertise; and (ii) religious authorities or ministers, priests, rabbis, or other persons whose position or duties in the nonprofit corporation or in a religious organization affiliated with the nonprofit justifies the director’s confidence. A director may also rely on information presented by a committee of the board of directors of which the director is not a member, as long as the director reasonably believes the committee merits confidence. Keep in mind, however, that directors are not entitled to this reliance if they know something about a matter under discussion that casts doubt on the reliability of the information or the person presenting it.

**Distributions**

A director must be careful to avoid approving an unlawful distribution, because this is an area of potential personal liability. A distribution is defined as the payment of a dividend or any part of the income or profit of a corporation to its members, directors, or officers. Make sure you understand what distributions are permitted and which ones are prohibited by CRNCA. Unlawful distributions include compensation in an unreasonable amount to a member, director, or officer. For this reason, make sure you can document why the board decided that the amount of executive
compensation is reasonable. One way to do this would be to adopt the methods suggested by the IRS for establishing the reasonableness of executive compensation under the intermediate sanctions rules. If you follow those guidelines, you can establish what the IRS calls a “rebuttable presumption of reasonableness,”xxxix which will not be binding on courts in Colorado, but nonetheless may be persuasive.

Another example of an unlawful distribution is a distribution upon dissolution that is not in conformity with Title 7, Article 134, which deals with voluntary, administrative, and judicial dissolution, as well as dissolution upon expiration of its period of duration. The most important requirement to keep in mind about distributions upon dissolution is that a nonprofit corporation exempt from tax under section 501(c)(3) of the Internal Revenue Code must distribute its assets for one or more of the 501(c)(3) exempt purposes, or to federal, state or local government for a public purpose.xlix

If you approve an unlawful distribution, you may be liable for any amount of the distribution that would not have been allowed by law. It won’t matter if you didn’t know the distribution was unlawful, if in approving it, you failed to meet the required standards of conduct for officers and directors.xli

Loans to Directors or Officers
Another way directors or officers may become personally liable to the corporation is if they approve or participate in a loan from the nonprofit to any of its officers and directors. This is not allowed under Colorado law. If any director or officer agrees to make such a loan, they are personally liable to the nonprofit for the entire amount of that loan until it is repaid.xlii

PROTECTION FOR VOLUNTEERS

Congress and our legislature have recognized the importance of supporting nonprofits and encouraging board service, so they have taken additional steps to shield directors and officers from personal liability as long as they fulfill their fiduciary duties. As a result, directors and officers serving in a voluntary manner are afforded some protection under both federal and state volunteer laws.

Federal Law
The Federal Volunteer Protection Act of 1997xliii (“VPA”) offers protection to unpaid officers and directors of nonprofits. Prior to enactment, it was possible for volunteers to get dragged into needless and unfair lawsuits, even though most of them were found not liable.xliv The VPA protects from liability an individual volunteer (including directors and officers), so long as certain criteria are met, including: (a) the volunteer either does not receive compensation other than reimbursement of reasonable expenses, or receives nothing of value in lieu of compensation in excess of $500 per year; (b) the volunteer must have acted within the scope of the volunteer’s responsibilities in the nonprofit organization; (c) the volunteer must not have acted in a manner that constitutes willful or criminal misconduct, gross negligence, reckless misconduct, or conscious, flagrant indifference to the safety of the individual harmed; (d) the volunteer, if required, must be properly licensed, certified, or authorized by the appropriate authorities in the state where the harm occurred; e) the volunteer must not have caused harm while operating a motor vehicle or other vehicle that requires a license and insurance to operate; and (f) the volunteer must not have acted while under the influence of alcohol or drugs, or in a manner constituting a crime of violence, international terrorism, a hate crime, sexual offense, or violation of other federal or state civil rights law.xlv
State Law
Colorado law provides immunity for volunteer directors, officers and trustees of nonprofit organizations who meet the following criteria: (a) The director or officer is not compensated for their duties other than reimbursement of reasonable expenses, meals at meetings or gifts not in excess of $1,000 per year; (b) the director or officer is acting within the scope of their official duties and functions; and (c) the director or officer did not cause harm through a willful and wanton act or omission. xlvi

ADDITIONAL RISK MITIGATION

Directors and officers should ensure, as part of their reasonable and prudent duty of care to the organization, that the organization maintains adequate insurance coverage, including a Directors & Officers (“D&O”) liability policy. D&O insurance provides coverage if the organization, or directors/officers individually, are sued for actions taken while serving in their official capacity to the nonprofit organization. An example would be board approval of an employment policy that becomes the basis for a discrimination lawsuit by a disgruntled employee. xlvii Protection under the VPA, state immunity law and liability insurance is designed to protect the officers and directors serving in a volunteer capacity, but it is important to note that the organization should ensure that this liability coverage shields the organization from liability for acts performed by the volunteer director or officer (subject to the official duties criteria above) which harmed a third party. Neither the VPA nor state law limit the organization’s liability for such actions.

ADDITIONAL RESOURCES
ManagementHelp.org: Offers links to several free articles and other resources on nonprofit directors’ duties.
Blue Avocado: Articles and newsletters on nonprofit issues.
Principles and Practices: Section on “Governance and Leadership” contains concise information on fiduciary duties.
Metro Volunteers: MV’s “Board Leadership Candidate” training provides a great overview of the duties and responsibilities of a nonprofit board member.
Stern v. Lucy Webb Hayes Nat’l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003, 1015 (D.D.C. 1974). This is one of the most frequently cited cases involving breach of fiduciary duties by nonprofit directors. In this decision, directors of a nonprofit corporation were found to have breached their fiduciary duties by, among other things, “failing to perform their duties honestly, in good faith, and with a reasonable amount of diligence and care.” xlviii This case also established that doing nothing can constitute a breach of fiduciary duty, especially when there is self-dealing. However, it’s worth noting that the court did not assess monetary damages, nor did it remove any of the directors. It only required the directors to read the court’s opinion.

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1 C.R.S. §7-121-101 to 137.
For example, in the seminal case of Smith v. Van Gorkom, the Delaware Supreme Court held directors of a for-profit corporation liable in a merger context where the directors were unable to convince the court that they had acted in a reasonably informed manner. 488 A.2d 946 (Del. 1985); see also Herrick K. Lidstone, Jr., The Business Judgment Rule: The Director's Standard of Care, 15 Colo. Lawyer 1809 (October 1986).

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C.R.S. § 7-128-401(6).