



# **Fiduciary Duties of Officer and Directors**

**BYLAWS AND POLICIES COMMITTEE**



# What is a Fiduciary?

A person who has a duty or obligation to act on behalf of and for the benefit of another, that is, the beneficiary.

- Defining characteristic of a fiduciary duty is that the fiduciary *must give priority to the interest of the beneficiary over self-interest and the interest of others.*



## **Fiduciary Duties of Officer and Directors** *example...*

You and Joe are the only ones left on an airplane that is about to crash. There is only one parachute and you have it. If you do not owe a fiduciary duty to Joe, Joe is in serious trouble. If you do owe Joe a fiduciary duty, you have to give him the parachute.



# Who are Fiduciaries?

Two ways to become a fiduciary:

1. Knowingly undertake to act on behalf of and for the benefit of another.
2. Enter into a relationship that the law imposes an obligation to act on behalf of or for the benefit of another.

# Officer and Directors of a corporation are in the second group – the fiduciary obligation is imposed by law



If you are an officer or director you are a fiduciary whether you like it or not or want to be one or not

- ❑ Cannot waive the duty
- ❑ Cannot delegate the duty itself
  - ❑ Can delegate to the extent of obtaining advice or information, but not the ultimate decision or responsibility
- ❑ Cannot have the position and not the duty

The duty does NOT change because the corporation is a nonprofit corporation



# Who are Directors and Officers?

- Directors are those identified in the articles or bylaws as directors
- Officers are *generally* those whose title or duties arise from the bylaws
  - Area of law where there may be substantial variations among the states
- There are other fiduciary positions such as agents, trustees, professionals, etc. that are beyond the scope of this presentation



# Who is the Beneficiary?

The corporation, ALL of it

The so-called “constituent director,” that is, a director elected or appointed by a subset or subgroup owes a fiduciary duty to the corporation, NOT to the subset or subgroup

# Who is the Beneficiary? *example...*



The Atlantis Youth Soccer Association's bylaws provide that the clubs in each of its five districts will elect a director to its board. Ralph is elected as the director for District 3. All of the clubs in District 3 strongly oppose a proposal at the Atlantis board meeting to expand the number of guest players allowed.

- Ralph reasonably believe that the proposal will harm and be contrary to the interest of District 3, but that the proposal is in the best interest of Atlantis YSA.
- How does Ralph vote on the proposal at the board meeting?



# Who is the Beneficiary? *example...*

- Pursuant to the bylaws, the registered competitive level coaches elect Jim as a director to the Atlantis YSA board of directors as the “technical directors’ representative.” The registered coaches overwhelmingly believe that Atlantis YSA should mandate the adoption of the 8 v. 8 format for all under-10 games because they consider it good for the players, the game, and Atlantis YSA.
- Jim reasonably believes that mandating the 8 v. 8 format will be contrary to the interest of Atlantis YSA because clubs will not be able to get enough coaches and other resources to do 8 v. 8 and because it will enable a competitor to attract Atlantis YSA members with the argument that they allow clubs to make decisions for themselves.
- How does Jim vote when the proposal to mandate the 8 v. 8 format for under-10 games in Atlantis YSA comes before the board?



# What are the Fiduciary Duties?

There are two basic duties, each of which impose a number of obligations.

The two are:

1. The duty of care
2. The duty of loyalty



# Duty of Care

The duty of care imposes the obligation to do *all* of the following:

1. Act in good faith
2. Act in a manner believed to be in the best interest of the corporation
3. Act with such care as a prudent person would use in similar circumstances



# Good faith means...

- Honesty of intention, including not taking advantage of another even when otherwise technically able to do so
- A failure to act in good faith occurs not only when the fiduciary is dishonest or motivated by an intent to harm or take advantage of the corporation, but also when the fiduciary consciously disregards the corporation's best interest
- A breach of the fiduciary duty does not require that the act or failure to act be contrary to any other law, rule or governing principle



# Duty of Care

Duty of care imposes  
an obligation to be  
informed, *including a  
duty to make  
reasonable inquiries*



## Duty of Care *example...*

Bob is a volunteer who has been running the Atlantis YSA competitive league for 10 years. Every year for the last 10 years Bob orally assured the board that the competitive league's revenues and expenditures are equal to each other and that there are no problems with the league's finances. Jane has just been elected as a new director to the board. What does Jane do, if:

1. Bob makes his usual oral assurance to the board during Atlantis YSA's annual financial review of operations and all the other directors say: "Great job Bob, let's move onto the next item."



## **Duty of Care** *example...*

2. Atlantis YSA's accountant tells the board that Bob needs to provide a written accounting of the competitive league's finances and the other directors say no need for an accounting as Bob has always done a great job, they have all known him for years, and they all trust him implicitly?



## Duty of Care *example...*

3. Bob announces that he is outraged and insulted by the suggestion that he be required to do an accounting because it impugns his personal integrity and he has worked hard for Atlantis YSA as a volunteer for over 10 years without every receiving a penny. He says that he will resign as the head of the competitive league immediately if a written accounting is required. Bob's resignation will leave the competitive league, which is midway through its playing season, in disarray.



## **Duty of Care** *example...*

4. Bob recants and produces a written accounting that shows 85 percent of all competitive league expenditures are for “miscellaneous” items.



## Directors *can* rely on information, reports, or statements from:

1. Officers and employees the director reasonably believes to be reliable and competent.
2. Legal counsel, public accountants, or other experts retained by the corporation as to matters within their expertise.
3. A committee of the board of directors if the director reasonably believe the committee merits confidence.

But can rely *only if* director does not have any knowledge (knew or should have known) that would make reliance unwarranted, that is, there are no “red flags.”



# Duty of Loyalty

Directors and officers owe a fiduciary duty of *undivided* loyalty to the corporation. The principal obligations imposed by this duty concern conflicts of interest, corporate opportunities, and obligations of disclosure and confidence.



# Conflicts of Interest

A conflict of interest exists whenever the interest of the director or officer is inconsistent with that of the corporation

Conflict does *not* have to be financial

- A director wants to be a coach of a team for which others are more qualified and available

Conflict may be direct or indirect

- Officer schedules games for teams that include the team he coaches



# Conflicts of Interest

Conflicts of interest include, but are *not limited* to:

1. Financial conflicts
2. Use of corporation's property or confidential information
3. Materially benefiting from position
4. Acting on behalf of an adverse interest
5. Competing with the corporation



# Conflicts of Interest

Because conflicts may be financial or non-financial in nature and because they may be direct or indirect, drafting conflicts-of-interest rules is difficult.

Apparently for this reason, many conflicts-of-interest rules only discuss direct financial conflicts and leave large areas where substantial problems may arise unaddressed, at least in the rules themselves.

The following is an example of one approach to a definition of a conflict-of-interest rules that includes all the major components of a conflict of interest and that would better protect against the very substantial harms they can cause than more limited rules do.



# Definition of a Conflict of Interest

## A “conflict of interest”

- a) Means any relationship, transaction, or arrangement that could influence, or reasonably be perceived as influencing, a person’s objectivity as a member of the board of directors or as an officer in regard to matters involving the corporation that could result in any personal benefit, either directly or indirectly, financially or otherwise, to that person, a member of that person’s family, a business partner or business associate of that person, or a close personal associate of that person; and



## Definition of a Conflict of Interest *continued...*

- b) Includes actual conflicts of interests, potential conflicts of interest, and a perceived conflict of interest; a perceived conflict of interest exists if a person not associated with the corporation, and aware of the facts, might reasonably entertain a doubt that the person would be impartial.



# Interested Director Statutes

Many states have a law that allow a *transaction* between a director and a corporation where the director has a material financial interest under *limited* circumstances.

The statutes commonly apply only to *individual transactions*, not on-going conflicts of interest

Compliance with the obligations of the statute are often mandatory and usually impose four requirements:

1. The corporation can enter into the transaction *only* for its own benefit
2. The transaction is fair and reasonable as to the corporation



# Interested Director Statutes

*continued...*

3. *Before* any part of the transaction was consummated, the board of directors approved the transaction in good faith by a majority vote that did not include the vote of the interested director *and* the board had knowledge of the material facts concerning:
  - a. **The transaction, and**
  - b. **The director's interest in it, and**
4. *Before* the board approved the transaction, the board considered and in good faith *after reasonable investigation* determined that the corporation could not have made a more advantageous arrangement with reasonable effort.

# CANNOT SERVE TWO MASTERS AT THE SAME TIME



- It is impossible to owe fiduciary duties to two competing interests at the same time without breaching the fiduciary duty as to at least one and possibly both beneficiaries
- Conflicts of interest are very damaging and corrosive because they necessarily put those with a conflict in the position of being strongly motivated to sacrifice the good of the organization to more limited, parochial interests



# Corporate Opportunities

The fiduciary duty of loyalty prohibits a fiduciary from engaging in a transaction that he or she knows or should know may be of interest to the corporation (often called “usurping the corporate opportunity”).

- The most commonly used legal test for defining what is a corporate opportunity is whether the matter may be in the same line of business as the corporation, *very broadly construed* to mean that the opportunity may be of interest to the corporation.

# Corporate Opportunities

*example...*



- Larry, a member of the Atlantis YSA board, is approached by the marketing manager of Razzle Dazzle, Inc., a clothing manufacturer. The manager tells Larry that his company is willing to sell 500 soccer uniforms at a 50% discount. Larry buys the uniforms at a discounted price and then sells them at a 25% discount to Atlantis YSA.
- As this is a “win-win” because Larry made 25% and Atlantis YSA got the uniforms with a 25% discount, has Larry done anything wrong?



# Candor and Confidentiality

A fiduciary owes a duty of candor to the corporation, that is, to disclose all material facts relating to anything of significance to the corporation

- The duty is *affirmative*. The fiduciary must come forward with the information without being asked about it or otherwise prodded.
- The disclosure must be *full and fair*. Cannot withhold part of the information or satisfy the obligation by half-truths.

# Candor and Confidentiality

*example...*



Fred, Atlantis YSA's vice-president of operations, learns that Bernie, his best friend and the Xavier club president, has asked Atlantis for a list of registered players and coaches. Bernie told Atlantis YSA's Executive Director he needed the list to mail out notices of tryouts for Atlantis YSA's competitive league. Bernie, however, told Fred that he really wants the list to do a mailing to solicit the players and coaches to leave Atlantis and join a competing organization. Can Fred remain silent?



# Duty to Maintain Confidences

A fiduciary owes a duty to the corporation to maintain its confidences

- Confidences generally means *anything* involving the corporation that is not known to the public, a matter or public record, or common knowledge
  - Confidences do *not* have to be secrets



# “CONFIDENTIAL INFORMATION”

“Confidential information” means “nonpublic information that a board member (or other person working or volunteering for the organization) has been given or learned in his or her capacity as a board member (or in such other capacity). Among other things, the term generally includes details of board deliberations and opinions expressed by and votes of fellow board members, and institutional work product, information from oral presentations, and opinions expressed by management, advisers, and retained experts.”

“Confidential information” is *not* limited to information learned or obtained in closed or executive session

# “CONFIDENTIAL INFORMATION”

*example...*



- The Atlantis YSA board of directors authorizes its president Allen to negotiate with City for the rental of fields and gives Allen the authority to agree to pay up to \$600 a day for the fields. Allen makes an offer to City to pay \$400 a day. Charlie, a board member, tells Sam, City’s Park and Recreation manager, that City can do better than Allen’s offer and get up to \$600 a day.