



# THE ATTORNEY OF NASSAU COUNTY

VOL. 13 NO. 1

SERVING NASSAU COUNTY'S LEGAL PROFESSION

JANUARY 2007

## Legal Pitfalls To Charitable Work

By Thomas J. Killeen

The Long Island community has a rich history of charitable involvement. Often this involvement leads to a request to take a more active role with the charitable organization, such as becoming a member of the Board of Directors or Trustees. Well-intentioned people are often surprised to learn that the mantle of "Director/Trustee" carries with it legal responsibilities and concomitant liability for failure to carry them out.<sup>1</sup>

### Duty of Care

Section 717 of the New York Not-for-Profit Corporation Law ("N-PCL") provides that "directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions." This is the so-called "duty of care". In analyzing whether a director has complied with the duty of care, the analysis does not relate to the outcome of a director's decision, but rather the process involved in the director having reached a decision. In other words, a director is not the guarantor that a decision will have a desired result, rather the issue is whether a director exercises good faith and reasonable diligence in arriving at the decision.

Courts are barred from examining "actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherances of corporate purposes . . . [A]bsent evidence of bad faith or fraud . . . the courts must and properly should respect [directors'] determinations." *Auerbach vs. Bennett*, 47 N.Y.2d 619, 629, 630-31 (1979). This is the so-called "Business Judgment Rule". The duty of care does not mandate directors can not rely on others. Indeed, N-PCL § 717(b) allows directors and officers, when acting in good faith, to rely on information and material prepared or presented by (1) officers or employees of

the corporation "whom the director believes to be reliable and competent in the matters presented," (2) professional advisors whom the director believes have the relevant professional expertise and (3) a duly delegated committee of the Board acting within its designated authority.<sup>2</sup>

The N-PCL contains a provision that may trip-up a well-intentioned, but inattentive, director. In essence, N-PCL § 719 provides that a director will be liable if (1) at a meeting, where the director is in attendance, improper action is taken by the Board and she or he doesn't object to the improper action at the time the vote is taken, or before the meeting is adjourned, or in writing (sent by registered mail) promptly after the meeting is adjourned, or (2) if the director is not at a meeting where the improper action is taken, she or he fails (a) to deliver written notice (again by registered mail) objecting to the action or (b) to cause his or her objection to be filed with the minutes of the proceedings within a reasonable time after learning of the action.

### Duty of Loyalty

Directors and officers of not-for-profit corporations also have the duty of loyalty. The duty of loyalty is based on the premise that a director must have an undivided loyalty to the organization and its mission, and cannot use any corporate asset, information or opportunity for her or his own private gain. While a breach of the duty of care is based on whether a director acted in good faith and prudently, the duty of loyalty will be breached by the act itself. For example, the duty of loyalty is breached where funds of a not-for-profit corporation are diverted to, or the property of the organization is used by or for the benefit of, a director or an entity affiliated with, or a relative of, a director. Two prime areas involving the duty of loyalty in the N-PCL involve director conflicts and loans. N-PCL § 715 provides, in essence, that the material facts of a conflict of interest must be disclosed in good faith, or known to

those who approve the transaction, and the transaction must be approved by a majority Board vote (excluding the vote of the interested directors), or the organization can avoid the transaction

unless it can be shown that the "contract or transaction was fair and reasonable as to the corporation at the time it was authorized".<sup>3</sup>

A statutory prohibition involves loans to officers and directors (N-PCL § 716), except loans made by a Type A not-for-profit corporation, such as a fraternal or social club, to its officers and directors if the Board of Directors finds that the loan is in furtherance of the organization's purposes and for a lawful "public objective". N-PCL § 1410(c)(2).<sup>4</sup>

### The Adelphi and Grasso Cases

Two particularly enlightening cases on the duty of care and the duty of loyalty obligations are the Report of the Board of Regents of the University of the State of New York, dated February 5, 1997 (the "Report"), involving claims against the then Adelphi University President and Board of Trustees based on compensation paid to the President and certain transactions involving members of the Board of Trustees, and the pending Attorney General civil case against Richard Grasso and others regarding payments made to Mr. Grasso by the NYSE, which was at the time of the payments, a Type A not-for-profit corporation.

On the Adelphi matter, the Report concluded that the Board had breached its duty of care in that the substantial increase in compensation to the President had not been properly authorized by the Board, was not based on any factually accurate criteria and, in fact, was based on inadequate or non-



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existent information.<sup>5</sup> Furthermore, the Report found violations of the duty of loyalty by two trustees and the President where one trustee's insurance business had received approximately \$1,125,000.00 from Adelphi and another trustee's advertising business had received approximately \$155,000.00, which payments were known only to the President and the two trustees. A subsequent lawsuit by the Attorney General against the former trustees and others resulted in a settlement requiring several million dollars to be paid by the defendants.

The Attorney General's civil action against Richard Grasso, the New York Stock Exchange, and others related to payments in excess of \$100 million made to Mr. Grasso by the NYSE.<sup>6</sup> The Attorney General successfully argued that a payment of retirement benefits to Mr. Grasso, before his retirement, was an unlawful loan prohibited by N-PCL § 716, that the compensation was excessive, in violation of N-PCL §202(a)(12), and not properly authorized by the Board. At the present time, the trial court has granted summary judgment to the Attorney General on liability, and has ordered a hearing as to the amount which Mr. Grasso must refund<sup>7</sup>, which the Court has concluded is in excess of \$100 million. The appeal of the decision was argued before the First Department on January 10, 2007.

### ***Indemnification/Insurance***

N-PCL § 722(a) allows for the discretionary indemnification by the organization of directors and officers, where the director or officer "acted, in good faith, for a purpose which he reasonably believed to be in . . . the best interests of the corporation . . ." It is permissible for a corporation to mandate defense and indemnity of directors and officers by changing the permissive word "may" in the statute to the mandatory word "shall" in the by-laws or the certificate of incorporation, and may authorize advances of defense costs prior to the outcome of the matter, subject to the obligation of the recipient to refund these payments if she or he were not legally entitled to receive them. Insurance may be procured to fund the corporation's obligations.

### ***Conclusion***

Any person who becomes involved with a charity should ensure that the level of involvement is not more than she or he is willing to undertake. Inattention as a director is no excuse if the duty of care and/or the duty of loyalty is breached by the other directors. Indemnity by the organization is permissible, but should be reviewed to determine the commitment of the organization (permissive or mandatory indemnification), the financial wherewithal to fund such obligation, and the limits and coverages provid-

ed by any insurance.

### **FOOTNOTES**

<sup>1</sup>This article concerns New York not-for-profit corporations and the New York Not-for-Profit Corporation Law.

<sup>2</sup>Certain matters may not be delegated to a committee, such as the ability to fix the directors' compensation for serving on a board or on any committee (N-PCL § 712(a)(3)). Other specific matters are expressly permitted to be delegated to outside professionals, e.g., N-PCL §§ 512 and 514 (cover investment activities).

<sup>3</sup>Exceptions to the conflict rule are found in N-PCL § 715(e), which permits the Board to fix compensation for directors, and N-PCL § 722, which permits the organization to defend and indemnify directors.

<sup>4</sup>The Attorney General and certain legal authorities also refer to a "duty of obedience" being applicable. The "Regulatory Role of the Attorney General's Charitable Bureau" publication discusses the duty of obedience and states that it "includes the obligation of directors and officers to act within the organization's purposes and ensure that the corporation's mission is pursued" (p. 4). One possible example of this duty may be the utilization of the assets of an organization set up to advance the cause of art being instead utilized to save animals.

<sup>5</sup>There was a claim the compensation increase had been based on Adelphi's academic progress, whereas the Report found admission standards had slid and the Baron's rankings of Adelphi had gone from "very competitive" to "competitive" to "less competitive." Moreover, comparable salary data had never been gathered, yet the President had become the 7<sup>th</sup> highest compensated university president in the country.

<sup>6</sup>The Attorney General claimed the payments were approximately 99% of the net income of the NYSE at the time.

<sup>7</sup>The Court has left open, however, to whom any such refund is to be made.

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