CHAPTER 7 DIRECTORS & OFFICERS OF PUBLIC BENEFIT CORPORATIONS

In This Chapter

- Introduction
- Selecting Directors
- Selecting Officers
- Compensating Directors and Officers
- Board Meetings, Minutes, and Other Corporate Records
- Officers' Duties
- Directors' Duty of Care
- Directors' Duty of Loyalty
- Self-Dealing Transactions
- Loans of Corporate Funds
- Distribution of Corporate Assets
- Other Liability Issues
- Frequently Asked Questions

INTRODUCTION

Every California nonprofit corporation must have a board of directors.[1] Also known as board members, directors serve many important roles: they oversee the work of officers and other senior management, they make policy decisions for the charity, and they ensure the organization is faithfully carrying out its charitable mission. The powers, duties, and limitations of what is expected and required from directors and officers are governed by California statutes and common law.[2] For instance, Corporations Code section 5210 provides that "the activities and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board."

This chapter explains some of the powers, duties, and limitations of directors and officers for public benefit corporations, including discussions on compensating directors and officers, and their fiduciary duties. Liability issues are also explained, such as when directors and officers may be held personally liable, and options for indemnification and insurance.

---

[1] (Corp. Code, §§ 5210 [nonprofit public benefit corporations], 7210 [nonprofit mutual benefit corporations], 9210 [nonprofit religious corporations].)
[2] (E.g., Corp. Code, §§ 5210-5215.)

SELECTING DIRECTORS

Legally, a public benefit corporation may operate with only one director.[3] However, most charities operate with three or more directors. This allows the charity to avoid potential conflict of interest problems, and gives the board members the ability to share in oversight responsibility.

As for the method of selecting directors, this varies. For instance, directors may be elected, either by voting members of the corporation (if any) or by the existing board of directors. Directors may also be designated by specified persons or entities given such right in the organization's governing documents. Additionally, depending on the bylaws, a corporation may have ex officio directors. Ex officio directors are individuals who are automatically directors of the corporation because they hold a particular position within or outside the corporation.[4]

Whatever the selection method, the method should be specified in the corporation's bylaws, as well as other provisions that govern the board of directors. This includes specifying the directors' powers and responsibilities, and provisions on resignation, removal, terms of office, and term limits of directors.

In selecting directors for board appointment, consider nominating and appointing candidates who have the appropriate levels of competency, experience, integrity, enthusiasm, and commitment to be fully engaged. Also, ensure the candidates fully realize the expectations and legal requirements that come with serving as directors, including the need to attend board meetings, as directors often accept their appointments without this awareness. Directors should understand they may be called upon to make difficult decisions to address critical situations on short notice. To inspire active engagement and responsible performance, directors should be provided with and encouraged to attend continuing education opportunities.

The board might also consider adopting bylaws that rotate leadership positions and limit the terms of the directors. For instance, directors may sometimes become entrenched in their ideas and positions, or may not devote enough time and energy needed to support the charity.

SELECTING OFFICERS

Every public benefit corporation must have at least three officer positions: a president (or chair of the board), a secretary, and a treasurer (or chief financial officer). Additional officers may be appointed if the corporation's bylaws provide for such officers. No person serving as the secretary or

---

[3] (Corp. Code, § 5151, subd. (a).)

[4] (Corp. Code, § 5047.)

treasurer/chief financial officer may serve concurrently as the president or chair of the board of a public benefit corporation. Also, there can be separate positions for president and chair of the board. The president is the chief executive officer of the corporation, unless otherwise specified in the corporation's governance documents. If there is no separate president, however, then the chair of the board often serves as the chief executive officer.[5] Generally, the president or chief executive officer is responsible for the day-to-day operations of the corporation. The treasurer or chief financial officer is responsible for the financial affairs of the corporation. Meanwhile, the secretary is responsible for maintaining corporate records, including board minutes.

Before agreeing to serve as an officer, the candidate should carefully read the description of duties to determine the requirements of the officer position.

Officers are usually appointed by the board of directors. The duties of officers and methods of their appointment should be clearly stated in the corporate governance documents, or in position descriptions adopted by the board. Charities may also have paid officers, who are employees of the charity. It may be appropriate to exclude employee-officers from also being members of the board because employee-officers depend on the corporation for their livelihoods – and as directors may be called to make decisions in the best interests of the corporation that might not align with their personal interests as employees. Also, because the board is required to exercise oversight over officers who are employees, it may be wise to exclude these officers/employees from also being members of the board.

COMPENSATING DIRECTORS AND OFFICERS

Most directors serve as volunteers and are not paid for their service as directors, other than reimbursement for actual expenses incurred in attending meetings (e.g., mileage, parking fees, meal costs). While directors may be paid for their services as directors (or as an officer should the director also be an officer of the organization), these payments must be fair and reasonable to the public benefit corporation in light of the services provided.[6] California law does not suggest what level of compensation is reasonable. This is determined on a case-by-case basis according to the particular facts and circumstances.

In California, there is also a limit on how many directors can be compensated for their professional or employment services; public benefit

[5] (Corp. Code, § 5213, subd. (a).)

[6] (Corp. Code, § 5235.)

corporations must be composed of at least 51 percent of directors who are "disinterested" persons.[7] Disinterested means that neither the director nor any member of the director's family is paid by the corporation to do anything other than act as a director. For example, a director who is a paid employee or whose spouse is a paid employee of the corporation is not a "disinterested person" for the purposes of this limitation.

In addition, the compensation including benefits paid to officers such as the president or chief executive officer, the treasurer or chief financial officer, or those with comparable responsibilities, must be reviewed by the board or an authorized committee, at the time of hiring, whenever the term of employment is renewed or extended, and whenever such compensation is modified.[8] In evaluating compensation, the board should analyze whether the proposed amount to be paid is in the best interest of the nonprofit. For instance, does the officer bring a lot of experience to the organization, and has he or she effectively and successfully improved or promoted the charity's programs? (Additional factors are listed below.) Note that if the charitable organization has declining revenue, is experiencing staff or donor dissatisfaction, or is subject to multiple lawsuits (which may reflect mismanagement), it may not be in the corporation's best interest to give the chief executive officer or chief financial officer a raise.

Furthermore, compensation paid to officers and directors cannot be concealed from donors or the public at large. Nonprofits that file IRS Form 990, Form 990-EZ, or Form 990-PF, must list compensation paid to directors, officers, trustees, and key employees (as defined by the IRS). In addition, these forms must list the compensation of its five highest-paid employees who are not directors, officers, trustees, and key employees, and earn more than $100,000 annually. The failure to provide this information may result in IRS fines. Form 990 also requires the charitable organization to provide explanations about the methods used to establish and approve executive compensation levels.

Both the IRS and Attorney General audit allegations of excessive compensation.

Both the IRS and Attorney General audit allegations of excessive compensation. The Attorney General may recover excessive compensation from the directors and officers who received the overpayment, and from the directors who approved the compensation if they failed to exercise due care. Likewise, the IRS may levy penalties for excessive compensation ranging from fines to revocation of an organization's tax-exempt status. IRS fines may be levied against both the person who received the overpayment and the directors who

[7] (Corp. Code, § 5227.)

[8] (Gov. Code, § 12586, subd. (g); Cal. Code Regs., tit. 11, § 312.1.)

approved or knew about the excessive compensation, but did nothing to prevent it.

In evaluating whether compensation is fair and reasonable to the nonprofit corporation, the board or its authorized committee tasked to review compensation should consider taking the following steps:

- Get the facts on the proposed compensation amount, including all "fringe benefits."
- Have a clear understanding of the job description, duties, and functions of the employee.
- Find out what other organizations with similar size, location, comparable programs, assets, and revenue pay their executives who have functionally comparable positions.
- Exclude the employee, director, or officer whose compensation is being evaluated from participating in the decision and ensure they have no role in researching or preparing the comparability data, or hiring a consultant to research and prepare a comparability study.
- Before attending any meeting scheduled to approve compensation packages, be prepared by reviewing the comparability study and data, review job descriptions, and evaluate past performance.
- Document the decision-making process at the time the board approves or the committee recommends the proposed compensation.
- The board minutes should include detailed discussions of the deliberative process, including all comparability studies relied upon, the date of approvals and compensation approved, list all board members who were present, and those who voted to approve or disapprove the proposed compensation. The minutes should also identify any board members who were present and had a conflict of interest, and what actions, if any, they took at the meeting.

BOARD MEETINGS, MINUTES, AND OTHER CORPORATE RECORDS

As demonstrated by the need to review the compensation of officers and to make other important decisions, the board of directors should meet regularly. The corporation's bylaws should contain provisions on board meetings, such as the required notice for meetings, the quorum requirement for meetings, the number of votes required for board approval, actions by unanimous written consent, and actions by committee. The Corporations Code sets forth requirements for many of

these items, and default provisions that apply if the bylaws are silent on these issues.[9]

Similarly, directors and officers should ensure compliance with various recordkeeping requirements.[10] For public benefit corporations, these include the duty to keep the following records:

- Minutes of board meetings and other proceedings;
- Current copies of the articles of incorporation and bylaws;
- Membership lists (name, address, and type of membership); and
- Adequate and correct financial and other records.[11]

For instance, at each board meeting, the directors should be prepared to review the minutes of the prior board meeting, and discuss any necessary edits before voting to approve the minutes. Directors should make sure the minutes accurately portray the board's discussion and decisions. The board's secretary should also provide a certification that the approved minutes are true and accurate copies.

These records are important not only to provide historical background and context supporting the board's decisions, but also because they may be considered prima facie evidence that meetings were held, and matters referenced in the minutes were actually decided.[12] False entries in the books, minutes, records, or accounts of a public benefit corporation or the alteration or removal of records may result in an enforcement action by the Attorney General or a district attorney.[13]

OFFICERS' DUTIES

As indicated above, officers sometimes are not members of the board of directors. Officers may be paid employees, and have titles such as chief executive officer, chief financial officer, secretary, chief operating officer, vice president, or executive director. Regardless of titles, officers are ultimately those who participate in the management of the corporation, and have some discretionary authority in managing the corporation's affairs.[14]

---

[9] (Corp. Code, §§ 5151, subd. (e), 5211-5212.)
[10] (Corp. Code, §§ 6215, 6813.)
[11] (Corp. Code, § 6320.)
[12] (Corp. Code, § 5215.)
[13] (E.g., Corp. Code, §§ 6215-6216, 6812.)
[14] (*GAB Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.* (2000) 83 Cal.App.4th 409, 420-421, disapproved on another ground in *Reeves v. Hanlon* (2004) 33 Cal.4th 1140.)

Officers stand in a fiduciary relationship with the corporation. Hence, they must scrupulously protect the interests of the corporation, exercise their powers in good faith and with best efforts, and refrain from doing anything that harms the corporation. For instance, officers cannot use their positions to further their private interests, or otherwise secure any personal advantage against the corporation.[15] In fact, officers who breach their fiduciary duty to the corporation may be liable for any damage their actions or inaction caused.

DIRECTORS' DUTY OF CARE

Directors are required to perform with the level of care that an ordinarily prudent person in a like position would use under similar circumstances. This includes making reasonable inquiries as needed.

Directors also act as fiduciaries. For instance, each director owes a duty of care to its nonprofit corporation and the corporation's charitable beneficiaries. For public benefit corporations, directors are required to perform with the level of care that an ordinarily prudent person in a like position would use under similar circumstances. This includes making reasonable inquiries as needed.[16]

To ensure the duty of care is met, a director should review the corporation's articles of incorporation and bylaws to better understand the corporation's mission, and the expected roles and responsibilities of directors and officers. Directors are also obliged to be informed about the nonprofit organization's program and operations.

Directors should also regularly attend board meetings and actively engage in meetings of the board and any board committees on which they serve. Before making any decision, directors should request and obtain all necessary background information and reports to promote informed decisions. Directors should use their own judgment in voting, and not simply follow the lead of other board members, or adopt the recommendations of management or staff. A director should not be afraid to ask questions at board meetings or request that matters be decided at a later date to allow for more in-depth deliberation.

In making decisions related to compensation or the charity's finances, directors should request reasonable access to management and advisors such as auditors and compensation consultants. In exercising due care,

[15] (*Bancroft-Whitney Co. v. Glen* (1966) 64 Cal.2d 327, 345; *Pigeon Point Ranch, Inc. v. Perot* (1963) 59 Cal.2d 227, 233, overruled on another ground in *Kowis v. Howard*, (1992) 3 Cal.4th 888; *GAB Business Services, Inc., supra,* 83 Cal.App.4th at pp. 416-417, disapproved on another ground in *Reeves v. Hanlon* (2004) 33 Cal.4th 1140; *Burt v. Irvine Co.* (1965) 237 Cal.App.2d 828, 850; *Daniel Orifice Fitting Co. v. Whalen* (1962) 198 Cal.App.2d 791, 797, 800.)
[16] (Corp. Code, § 5231, subd. (a).)

directors should proactively demand and review financial reports and statements.

If directors do not abide by the duty of care owed to their public benefit corporation, they may be held personally liable to the corporation.[17]

DIRECTORS' DUTY OF LOYALTY

Each director also owes a duty of loyalty to its nonprofit corporation. For public benefit corporations, this means the director must make decisions he or she believes is in the best interest of the corporation, as well as act in such best interest.[18] For instance, the director is obligated to act with undivided loyalty, be fair in his or her dealings with the nonprofit, and must not seek to benefit personally from the activities or resources of the nonprofit.

Duty of loyalty issues typically arise when there is a conflict of interest between the charity's best interests and the personal interests of the director, as exemplified in the Self-Dealing Transactions section below. And like the duty of care, directors who breach their duty of loyalty may be held personally liable to the corporation.[19]

SELF-DEALING TRANSACTIONS

A self-dealing transaction involves:

- A contract, agreement, or other action affecting the assets or income of a public benefit corporation;
- To which the corporation is a party; and
- In which one or more of its directors has a material financial interest.[20]

For example, a self-dealing transaction may occur when a charity pays a fee, commission, or rent, or enters into a contract with, that results in giving a material economic benefit to a director, or his or her company or partnership. Since the director's first duty of loyalty is to the corporation, it may be difficult for a director to carry out that duty if he or she is also looking to make a profit from transacting business with the corporation.

Self-dealing transactions between a director and a public benefit corporation are inherently suspect. Yet, there are situations when it may be advantageous for the corporation to enter into such a transaction, such as when the corporation is treated fairly and the director is not unduly

[17] (Corp. Code, § 5231, subd. (c).)
[18] (Corp. Code, § 5231, subd. (a).)
[19] (Corp. Code, § 5231, subd. (c).)
[20] (Corp. Code, § 5233.)

compensated. This might occur when a corporation has the opportunity to rent office space from a director at a lower rate than would be available on the open market.

The board must follow the procedures set forth in Corporations Code section 5233 to validate a self-dealing transaction and before consummating it. These procedures require a determination by the board of directors that the corporation entered into the transaction for its own benefit, the transaction is fair and reasonable at the time it entered into the transaction, and that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances. In reaching these conclusions, the board must act in good faith and there must be a full disclosure of all material facts. Further, the board must approve the transaction by a majority of directors then in office without counting the director subject to the conflict of interest.

When a self-dealing transaction is not fair to the corporation and results in unreasonable charges or excessive profit to the interested director, the corporation suffers damage. The Attorney General and certain other persons may sue the directors to recover the actual damage suffered by the corporation, plus interest, and in some cases punitive damages. Any damages recovered are returned to the corporation. The Attorney General typically also seeks the permanent removal of the interested directors and other directors responsible for the damage.

If the "disinterested" directors fail to review a self-dealing transaction in good faith as provided in Corporations Code section 5233, and instead simply rubber stamp the transaction or approve the transaction to protect the interested director, the self-dealing transaction is not deemed validated and all directors may be held liable for any damages incurred by the charity.[21]

For added protection, the board may consider submitting a notice of the proposed self-dealing transaction to the Attorney General.[22] This protects the board against claims of improper transactions and potential damages. The Attorney General seeks to evaluate these transactions in 60 days.[23] See Chapter 11 for more information.

[21] (Corp. Code, §§ 5231, 5233, subd. (h).)
[22] (Cal. Code Regs., tit. 11, §§ 999.1, 999.2, subd. (b).)
[23] (Corp. Code, § 5233, subd. (d); Cal. Code Regs., tit. 11, § 999.1, subd. (d).)

LOANS OF CORPORATE FUNDS

With narrow exceptions, a public benefit corporation may not grant loans to its directors or officers without Attorney General approval. One exception involves advancing money for an expense reasonably anticipated to be incurred in the performance of a director's duties, provided the director would otherwise be entitled to reimbursement for the expense.[24] Another exemption would be secured loans for the purchase of a principal residence located in California to attract talented officers.[25] Directors may be held personally liable for authorizing prohibited loans and guarantees.[26]

Unless the loan is specifically exempt by statute, the board of directors should seek the Attorney General's approval of a prospective loan.[27] The Attorney General evaluates all material facts supporting the board's proposed decision to grant the loan, including whether the loan is in the best interest of the charity, whether the loan terms are fair to the corporation, and whether the loan is secured. The Attorney General also reviews the corporation's financial statements, founding records, and board minutes to evaluate whether the charity is authorized by its bylaws to grant loans and whether the loan would be a suitable investment given its financial statements.[28] The Attorney General seeks to respond to requests for approval of loan and guarantee agreements within 60 days after receipt of all material facts related to the proposed action.[29]

DISTRIBUTION OF CORPORATE ASSETS

Directors may also be personally liable for authorizing or receiving a prohibited distribution of the public benefit corporation's assets.[30] Examples of prohibited distributions include:

- Transfers of corporate funds or assets to directors, officers, or members without fair consideration;
- Payment of excessive or unauthorized salaries, non-contractual benefits or bonuses;
- Improper gifts of the corporation's assets to individuals; and

---

[24] (Corp. Code, § 5236, subd. (a).)
[25] (Corp. Code, § 5236, subd. (c).)
[26] (Corp. Code, § 5237, subd. (a).)
[27] (Corp. Code, § 5236.)
[28] (Cal. Code Regs., tit. 11, § 999.2, subd. (c).)
[29] (Cal. Code Regs., tit. 11, § 999.1, subd. (d).)
[30] (Corp. Code, § 5237, subd. (a).)

- Other uses of corporate assets that violate the charitable trust under which they are held.

OTHER LIABILITY ISSUES

Although situations where personal liability may be incurred are discussed above and other scenarios may apply,[31] directors and officers of nonprofit corporations are generally not personally liable for the debts, liabilities, or obligations of the corporation.

Volunteer Directors and Officers

Along those lines, volunteer directors and officers of public benefit corporations can avail themselves of statutory liability protections when certain criteria are met. Under Corporations Code sections 5047.5 and 5239, volunteer directors and officers are protected from liability in legal actions for claims of negligence involving conduct within the scope of their duties and performed in good faith. Also, the statutory protections are expressly conditioned on the corporation maintaining general liability insurance of certain amounts (based on the corporation's annual budget).[32]

Volunteer directors and officers are not protected from liability in lawsuits brought by the Attorney General or from lawsuits brought against them for self-dealing transactions or improper distributions.

However, these statutes do not protect a volunteer director's or officer's acts or omissions that are intentional, reckless, grossly negligent, outside the scope of their duties, or not made in good faith. Also, volunteer directors and officers are not protected from liability in lawsuits brought by the Attorney General or from lawsuits brought against them for self-dealing transactions or improper distributions.

Who May File Lawsuits

When a fiduciary, such as a director or officer, violates his or her duty of loyalty or care towards the charitable organization, and it results in lost income, assets and other damages, a breach of charitable trust action may be filed. Likewise, if a charitable organization departs from its charitable purpose or if funds solicited for specific purposes are diverted for other unrelated purposes, this type of conduct could result in a breach of charitable trust action to recover the lost donations. A breach of charitable trust action seeks to recover the loss of charitable assets, for the benefit of the charitable organization. Various persons have standing to file a lawsuit to remedy a breach of charitable trust action, such as:

- The Attorney General;
- Members of the corporation, if the corporation's bylaws provide for membership;

---

[31] (E.g., Corp. Code, §§ 6215, 6811.)

[32] (Corp. Code, §§ 5047.5, subd. (e), 5239, subd. (a)(4).)

- The corporation's directors or officers;
- A person with a reversionary, contractual, or property interest in the assets subject to such charitable trust, and
- The corporation itself.[33]

The Attorney General files these types of lawsuits as part of his oversight power to protect charitable assets, and to ensure compliance with trusts, and a corporation's articles of incorporation and bylaws.[34] This oversight is an important function as charitable organizations exist to benefit the public in general. The Attorney General may intervene in an action brought by others.[35]

A corporation's members and others can bring a lawsuit in the name in of the corporation. These are called "derivative actions" because they are filed on behalf of the corporation, and not the person or entity filing suit.[36] Derivative actions against directors and officers usually seek money damages from the responsible party. Such damages are paid to the corporation or, when circumstances make it more appropriate, to a charity with the same or similar charitable purpose. The Attorney General must be given notice of any derivative action.[37]

Indemnification and Insurance

California law allows a public benefit corporation to indemnify directors, officers, and agents of the corporation for costs and expenses of civil litigation under certain circumstances.[38] The corporation's articles of incorporation and bylaws may also contain provisions on indemnification. Note that any indemnification of directors and officers must be consistent with California law and the corporation's governing documents.

Many nonprofit corporations also purchase "directors and officers" insurance to provide a source of payment for litigation costs, in addition to the corporation's own funds. Public benefit corporations may purchase indemnification insurance to protect directors and officers from liability for most claims, but not for self-dealing.[39]

---

[33] (Corp. Code, § 5142, subd. (a).)
[34] (Gov. Code, § 12598, subd. (a).)
[35] (Corp. Code, §§ 5142, subd. (a), 5250.)
[36] (Corp. Code, § 5710.)
[37] (Corp. Code, § 5142, subd. (a).)
[38] (Corp. Code, § 5238.)
[39] (Corp. Code, § 5238, subd. (i).)

FREQUENTLY ASKED QUESTIONS

"Our charity has a $200,000 surplus for the current year. How should the directors invest this surplus?"

Directors are required to make prudent investments of charitable assets under their control in accordance with applicable law (including the Uniform Prudent Management of Institutional Funds Act[40]), and are permitted to rely on the advice of investment experts if it is reasonable to do so under the circumstances. Directors may be held personally liable if they fail to act in this way and loss results to the charity. For example, directors may be liable for lost earnings on surplus funds left in a non-interest-bearing account, if doing so would not be in accordance with their duties.

"Our charity is considering paying our chief executive officer a percentage of the charity's net proceeds as a bonus. Can we do this?"

While bonuses can be paid to an officer, if the bonus is tied to revenue, it may be considered excessive compensation and an improper distribution of charitable assets.

"The board recently became aware that one of the directors was engaging in a self-dealing transaction. This interested director planned our charity event. We thought he was organizing the event for free. We were not aware, and we did not authorize the payment of his services from donations he received from ticket sales. What are our obligations now?"

Assuming this was not a theft or embezzlement, but an honest misunderstanding or miscommunication, the board should demand a full accounting of all profits and payments received by the interested director. The board should review the bylaws to consider steps in removing the interested director. The board of directors should have been told all of the material facts by the interested director, including payments he anticipated receiving, before the board gave him authority to plan, organize, and solicit donations for a charity event. If the accounting provided by the interested director reveals the payments amounted to a material financial interest, the board should demand the funds be returned. If the interested director refuses to return the funds, the board should consider filing an action against the interested director to recover the funds and remove the director from the board; the Attorney General must be joined as an indispensable party.

[40] (Prob. Code, § 18501 et seq.)

The self-dealing transaction must also be disclosed on the charity's Form RRF-1 filed with the Attorney General's Registry of Charitable Trusts,[41] and in IRS filings. The board should also file a complaint with the Attorney General.

If this transaction was not the result of a miscommunication or misunderstanding, and instead was embezzlement or theft, the board should file a complaint with the local police department, and must report the crime in the Form RRF-1 and in IRS filings.

"Our charity has not had board meetings in many months and we are having problems scheduling meetings in-person. What are our options for meeting by phone or video conferencing?"

The board should consult its bylaws to determine if meetings must be in person. If the bylaws are silent on this issue, Corporations Code section 5211, subdivision (a)(6), allows directors to meet by phone or video conferencing.

[41] (Corp. Code, § 5233.)