Directors’ Fiduciary Duties – Duty of Loyalty

Bill Boyd
Nyemaster Goode, P.C.
Des Moines, IA
515-283-3172
wlb@nyemaster.com

The Revised Iowa Nonprofit Corporation Act recognizes two types of fiduciary duties of directors of nonprofit corporations: The duty of care and the duty of loyalty. This article focuses on the duty of loyalty. A previous article focused on the duty of care.

The Revised Act requires that that each member of the board of directors of the corporation, when discharging the duties of a director, act in good faith and in a manner that the director reasonably believes to be in the best interests of the corporation. Iowa Code section 504.831(1). This means that a director is required to exercise his or her power in the interest of the nonprofit corporation not in his or her own interest or the interest of another person or entity. As a result, a director should avoid using his or her position in a manner that would result in pecuniary gain for the director or a member of the director’s family. The duty of loyalty can be viewed as covering both conflict of interest and corporate opportunity situations.

Conflict of interest transactions are not necessarily prohibited for a nonprofit corporation. In fact, they may be beneficial because a director may be able to offer a good or service to a nonprofit corporation at no charge or at a price that is below fair market value. Still, conflict of interest transactions can be detrimental to a nonprofit corporation when it pays for a good or service in an amount that exceeds a fair price or advantages the director to the detriment of the organization. As a result, it is important that conflict of interest situations be managed through a process that helps prevent directors from taking advantage of the entity as a result of their position on the board.

The Revised Act provides the following “safe harbor” for handling these situations: A conflict of interest transaction is not voidable by the corporation on the basis of the director’s interest in the transaction if the transaction was fair at the time it was entered into or is approved as follows:

- The material facts of the transaction and the director’s interest are disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee (excluding any interested directors) authorized, approved, or ratified the transaction; or

- If the organization has voting members, the material facts of the transaction and the director’s interest were disclosed or known to the members that (excluding any interested members) authorized, approved, or ratified the transaction.
As noted above, under certain circumstances, a transaction between a nonprofit corporation and its director, officer or key employee (or an entity in which the director has a financial interest) may be acceptable and beneficial to the corporation. In order to allow (and protect such types of transactions from challenge), the process set forth above should be followed. This can be accomplished through a conflict of interest policy or bylaws provision that incorporates the requirements set forth above. A policy also might require that the interested board member, officer or key employee be excluded from participation in the approval process, including a request that the individual be excused from the meeting at which the board will be voting on the matter after the individual has provided any requested information on the proposed transaction. For any transaction involving a conflict of interest, it is important that the process followed by the corporation in handling the matter be documented in the minutes of the meeting.

Conflict of interest transactions are also a focus of the IRS as it relates to nonprofits that are exempt from federal income tax. The IRS expects such nonprofits to have a conflict of interest policy in place that covers directors, officers and key employees. In addition, it is important to have those individuals disclose to the organization any potential conflicts on an annual basis. Such disclosure can be accomplished through a survey/questionnaire to be completed by those individuals.

The second type of situation that might involve the duty of loyalty is when a director becomes aware of an opportunity made available to the corporation that the director would like to pursue for his or her own personal benefit or the benefit of others unrelated to the entity. A director who engages in a transaction that the director should reasonably know may be of interest to the corporation should disclose the transaction to the board of directors in sufficient detail and in adequate time to enable the board to act or decline to act with regard to such transaction.

Iowa law also provides that no loans shall be made by a corporation to its directors or officers except in limited situations described in the Revised Act. Any director or officer who assents to or participates in the making of any such loan shall be liable to the corporation for the amount of such loan until the repayment thereof. Iowa Code section 504.834.

Finally, the duty of loyalty requires that a director should not normally, in the regular course of business, disclose information outside of the organization about the organization’s legitimate activities unless they are already known by the public or are of public record. This duty of confidentiality exists because the disclosure of the information could be detrimental to the interests of the organization.