

PRESENTATION TO KIAWAH ISLAND COMMUNITY ASSOCIATION, INC.
BOARD OF DIRECTORS

Overview of Duties and Rights of SC Nonprofit Corporation Directors

March 25, 2024

Prepared by Rosen Hagood, LLC

rosenhagood.com

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Role of Directors

- SC Nonprofit Corporation Act (SCNCA), SC Code Ann. §§ 33-31-100 *et seq.*, provides that all corporate powers of a nonprofit corporation must be exercised by or under the authority of its board and ***the affairs of the association must be managed under the direction of its board***
- Art. VI §§ 1 and 2 of KICA's bylaws outline both the powers and duties of directors
 - Board has ultimate authority over management and conduct of business and affairs of association
 - The association's business is exercised by or under the direction of Board
- The Board of Directors ***acts as a body (collectively)***
 - An individual director, acting alone, has no power; rather, each director exerts his or her power as one participating element in the board of directors
 - A director directs, but does not perform, the association's activities
 - Board is not expected to operate the association on day-to-day basis
 - Board's decisions will be carried out by officers, employees, and agents

Board's Powers Generally

- Manage and control business and property of association
- Enforce Association's covenants and bylaws
- Pay for goods/services necessary for association's functions from funds received through assessments
- Mortgage association property and pledge association's revenues as security for loans to association
- Perform any other obligations imposed by Articles of Incorporation, Covenants, Bylaws, the SCNCA, and SC Homeowners Association Act (SCHAA), SC Code Ann. §§ 27-30-110 *et seq.*

Role of Directors (continued)

- Directors' responsibilities are limited to overseeing the association's operations
- Directors have monitoring responsibilities
- However, directors are not personally responsible for actions or omissions of officers, employees, or agents of association as long as those persons have been prudently selected and the directors reasonably relied upon such officers, employees, or agents

Board's Fiduciary Relationship

- Board of directors have *fiduciary relationship* to the association's members comparable (but not identical) to obligation a board of directors of a business corporation owes to its stockholders
 - owe fiduciary duties (e.g., duty of care, duty of loyalty)
 - imposes obligation of trust and confidence
- KICA qualifies as a tax-exempt nonprofit operated exclusively for the promotion of social welfare pursuant to IRC §501(c)(4)
 - Must be operated to further the common good and general welfare of community
 - Must primarily serve the community rather than private interests of members
 - Will not qualify under §501(c)(4) if activities benefit only a select group of members
- Each director shares the same fiduciary duty to act *in the best interest of the entire organization* (not simply particular groups or portions of membership)

Board's Fiduciary Relationship (continued)

- The mere fact KICA is non-profit or that director is unpaid volunteer does not relieve director from high standards of trust and responsibility that fiduciary relationship requires
- A director is presumed to have knowledge of duties and responsibilities imposed upon directors the moment he/she accepts position
 - Ignorance or inexperience is not an excuse
- Failure to comply with fiduciary responsibilities could potentially lead to personal liability—*i.e.*, personal assets are potentially at risk
 - Directors are granted statutory immunity for certain acts or omissions
 - Directors may be entitled to indemnification for certain acts or omissions
 - Business judgment rule also may protected directors

Obligations and Responsibilities of KICA Board of Directors:

- Director must act ***within the scope of the association's authority***
 - Must act within scope of powers granted bylaw, charter, articles of incorporation, and bylaws
- Directors also have ***two primary duties*** or obligations:
 - [1] ***duty of care***
 - [2] ***duty of loyalty*** to corporation
- These duties are the common terms for the standards that guide all actions a director takes

Duty of Care:

- Director must discharge his/her fiduciary duties:
 - in *good faith*,
 - with the *care an ordinarily prudent person* in a *like position* would exercise under *similar circumstances* (i.e., due care and diligence), and
 - in a manner the director *reasonably believes* to be in the *best interests of the corporation as a whole*
- These requirements are typically referred to as the director's "duty of care"

Duty of Care (continued):

- Director generally may discharge duty of care by:
 - ***regularly attending board meetings***
 - attendance at committee meetings and being active in deliberations
 - *Note*: SCNCA does not allow directors to vote by proxy
 - ***exercising independent judgment***
 - sharing equally in the responsibilities of board
 - directors may give weight to views of directors or others with special expertise, but must make independent decision on any questions presented for board or committee determination
 - decisions must be based on what is in association's best interests, not the interests of any constituent group
 - ***having adequate information*** (should be informed judgment)
 - directors need to have adequate source of information flow (management, staff, etc.)
 - request executive summary of technical or specialized information
 - require information far enough in advance of decision
 - ask questions at board meetings for clarification and request further information

Right to Rely Upon Information:

- In discharging his or her duties, a director is entitled to ***rely on information, opinions, reports, or statements***, including financial statements and other financial data, ***if prepared or presented by:***
 - (i) one or more ***officers or employees*** of the corporation who the ***director reasonably believes*** is ***reliable and competent*** in the matters presented or
 - (ii) ***legal counsel, public accountants, or other persons*** (e.g., experts or consultants) as to matters the ***director reasonably believes*** are within the person's ***professional or expert competence***
 - (iii) a ***committee of the board*** of which the director is not a member, as to matters within its jurisdiction, if the director ***reasonably believes*** the committee ***merits confidence***

Right to Rely Upon Information (continued):

- Right to rely has both ***objective*** and ***subjective*** components
 - Objective in that director must reasonably believe the action is in best interest of association
 - Reasonable person standard applies
 - Subjective in that director must in fact believe action is in best interest of association
 - Must really or actually believe
- Right to rely ***requires actual reliance by board member***
 - Director must have read material, been present at meeting where it was presented, or otherwise have evaluated it

Right to Rely Upon Information (continued):

- The rules of reliance never apply if director has *personal knowledge* that would make reliance on the information provided by any of the above persons unwarranted
 - Ex.: Board member could not rely solely upon manager's decision to terminate an employee's employment contract "for cause" in circumstance where board member had personal knowledge of information contradicting management's decision
- If director has reasonable basis to be suspicious or is in fact suspicious, then duty of care requires director to make further inquiry

Practical Suggestions for Best Practices:

- Attend regularly scheduled meetings of directors and those committees to which the member has been assigned
 - Board should meet on regular basis with schedule fixed at beginning of year
 - Art. V § 1 of KICA's bylaws requires at least 6 regular board meetings annually as set forth on annual calendar which shall be published no later than 5 business days following annual meeting of members
- Adopt and follow a standard form of meeting agenda
 - Art. V § 6 of KICA's bylaws requires meeting agenda be published at least 3 business days prior to meeting
 - Shall include list of topics; topics and order are stated in bylaws
 - Should include copies of materials to be presented at meeting
- Executive sessions on regular basis
 - Held outside of presence of management and staff or, if needed to assist the Board with its duties, with limited management or staff present
 - Encourages candid discussions

Practical Suggestions for Best Practices (continued):

- Minimize action by written consent as opposed to resolution adopted at a regular or special meeting of board
 - Use only for transacting routine business or specific actions fully discussed at prior board meeting
 - Avoid using for major activities or decisions
- Limit voting by email
 - Should not become a routine substitute for regular meetings
 - Art. V § 9 of KICA's bylaws limits to decisions made by *unanimous vote* of board

Practical Suggestions for Best Practices (continued):

- Adopt a regular schedule of information to be provided to directors
 - Regular schedule or system of reports/data to be provided to board
- Distribute information in advance of board meetings
 - Art. V § 6 of KICA's bylaws requires copies of materials to be presented at meeting should be sent with agenda at least 3 business days prior to meeting
- Discuss with staff most efficient way for them to provide board with necessary information such that it doesn't impede staff's operational responsibilities
- Directors should ask questions, get answers, and take action whenever there is concern or "red flag" identified by a director
 - Investigate and take appropriate corrective action when become aware of unethical or illegal acts of corporation, officers, or employees
 - If director has issue with a staff member, he/she should first raise it to the COO; if the issue is with the COO, then with the Chairperson and/or fellow board members
- Adopt and adhere to rules or standards of procedure to be followed by board members, employees, and agents

Practical Suggestions for Best Practices (continued):

- Make available minutes of board and committee meetings to board members regularly
- Maintain some form of record of executive sessions
 - Record times when board went into and came out of executive session
 - Record whether action was taken and, if so, notation of general or specific items discussed
 - Consider keeping separate set of minutes for executive session
 - Art. V § 8 of KICA's bylaws requires any action taken in executive session, including how each director voted, shall be recorded in minutes without disclosing identify of members or employees associated with such actions
- Directors should review minutes to ensure accuracy
 - Try to send draft as soon as possible after meeting when memories are fresh
- Have procedure to approve minutes at next regular board meeting

Duty of Loyalty:

- Director must exercise their powers in ***best interests of the association***, rather than in their own interests or the interests of another entity or person
 - A director shall not use a corporate position for individual personal advantage
- Duty of loyalty primarily relates to:
 - ***conflicts of interest***,
 - ***corporate opportunity***, and
 - ***confidentiality***

Conflicts of Interest:

- SCNCA, SC Code Ann. § 33-31-831, addresses director conflicts of interest
 - A conflict-of-interest transaction is “voidable,” unless “fair” to association at time it was entered **or** it was approved by a majority of disinterested directors
 - A conflict-of-interest transaction is not automatically void, but is voidable
- Association’s articles, bylaws, or a board resolution **may impose additional requirements** on conflict-of-interest transactions
 - Art. IV § 13 of KICA’s bylaws does this
- Art. IV § 13 includes written conflict of interest policy for directors
 - Mandates that directors **disclose** facts or relationships which present a conflict of interest
 - Director must **abstain** or **recuse** himself/herself from transaction in which has conflict
 - Includes process for **resolving disputes** involving whether a director has a conflict
 - Clarifies that certain transactions are not a conflict-of-interest transaction

Conflicts of Interest (continued):

- Board members have a duty to avoid ***potential or apparent conflicts of interest***
 - A conflict of interest generally can be present when a director has a ***material financial, business, or personal interest*** in a proposed contract or transaction to which the association is a party
 - Can occur ***directly or indirectly***
 - Can occur even though director receives no direct monetary or tangible benefit from transaction
 - This can sometimes be difficult to apply in individual cases
- Important for board members to be ***open and honest*** with their fellow board members

Conflicts of Interest (continued):

- Board member who has a potential conflict with respect to a particular transaction ***should affirmatively disclose***:
 - whether they have a potential conflict of interest with respect to any transaction, business decision, or other matter in which the association is involved
 - whether they have a financial, business, or personal interest in an entity with which the association is or will be doing business
 - whether individuals related to them have a financial, business, or personal interest in an entity with which the association is or will be doing business
 - whether they serve as a director, member, or employee of either a competitor of the association or an entity with which the association is or will be doing business

Conflicts of Interest (continued):

- When board considers or makes a decision on a transaction, the board member who has a potential conflict with respect to a particular transaction should ***abstain from participating*** in the negotiations and decisions surrounding that decision
 - Best that he/she should not be present in room during discussions relating to the transaction and absence and abstention should be noted in minutes
 - If decision is made that approval of transaction is in best interests of association, the decision should be made by disinterested majority of board (not single director) after full disclosure of material facts as well as the director's interest therein and the transaction must be fair to the association
- Association should ***fully document its actions***
 - For example, if association decides to deal with entity in which a board member has an ownership interest, corporate records should show interest was disclosed and that board decided to do business with entity based on fairness of transaction and best interests of association
 - Thorough documentation of fair value is important
 - All interested party transactions must be disclosed on IRS Form 990, Schedule L

Conflicts of Interest:

- A best practice is for board members to complete annual statements disclosing affiliations
 - Board should review and update disclosure statements periodically
- KICA's Financial Controls Manual Chap. 19 has annual conflict of interest disclosure requirement for directors, employees, committee/task force members
 - Also requires contractors to disclose possible conflicts of interest to KICA

Corporate Opportunity:

- In some situations, law obligates a board member to treat a business opportunity as a ***“corporate opportunity”*** that must first be offered to association before director can take advantage of it outside his/her role as director
 - For example, when director learns of potential transaction because of position with association
- Record should be made of disclosure and board’s abstention (if any) from exercising opportunity
- Director should still be cognizant of any appearance of impropriety that would be created if he/she entered into such a transaction

Confidentiality:

- Except in ordinary course of association's business, directors should refrain from disclosing the association's business activities unless they are known by public or are of public record
- In normal course of business, directors should treat as confidential all matters involving the association until there has been general public disclosure or unless information is matter of public record or common knowledge
- An individual director is not a spokesperson for the association
 - Disclosures to public (press) should be made only through association's designated spokespersons (e.g., Board Chair, public relations employee)

Attorney-Client Privilege:

- SC follows the “entity rule” with respect to the attorney-client privilege
 - Lawyers representing nonprofit corporations owe their professional obligations to the corporation and not to the board as a whole, or to any individual director or officer
 - “A lawyer employed or retained by an organization **represents the organization** acting through its duly authorized constituents.” S.C. RULE OF PROF. CONDUCT 1.13(a).
 - Individuals speaking to association’s counsel on behalf of association are not themselves clients of the association’s counsel.
- Confidential communications between the corporation’s employees and agents with the corporation’s legal counsel generally are **protected by privilege**
 - “In order to establish the attorney-client privilege, it must be shown that the relationship between the parties was that of attorney and client and that the communications were of a confidential nature.” Marshall v. Marshall, 282 S.C. 534, 538, 320 S.E.2d 44, 47 (Ct. App. 1984)

Attorney-Client Privilege (continued):

- The privilege belongs **to the association**. Tucker v. Honda of S.C. Mfg., Inc., 354 S.C. 574, 577, 582 S.E.2d 405, 407 (2003)
 - The association's current control group (e.g., Board) decides whether to assert the privilege or relinquish it
 - Majority of board must decide to waive privilege; cannot be waived by individual board members or minority of board
 - Because the association is the client, the association has the authority to withhold privileged information from an individual director
- In certain circumstances, the **privilege can be voluntarily lost or waived**, such as when the client (through an officer, employee, or other agent) intentionally discloses the confidential information to a third party
 - The Board should caution its members and other representatives of the association against disclosure of such confidential information to persons other than the association's counsel
 - Law in SC is presently uncertain whether a director's *unauthorized* disclosure of privileged material to a third party would effect a waiver

Attorney-Client Privilege (continued):

- KICA's bylaws Art. VIII § 7 allows for creation of *litigation committees*, which can employ and pay separate and independent legal counsel
 - Litigation committee would control decision to assert/waive privilege
- Art. VII, § 7 of KICA's bylaws says COO may act as *conduit* for transmittal of privileged information between Board and association's legal counsel without waiving privileges

Statutory Immunity from Suit or Liability:

- Different sections of SCNPA give protections to directors from potential liability
 - These statutes are more protective of nonprofit directors than directors of business corporations
- **33-31-830(d):** Says a director *meeting standards of duty of care* (act in good faith, act with care of ordinarily prudent person, and act in manner director reasonably believes to be in best interest of corporation) is ***not liable*** to the ***corporation, a member, or any other person for any action taken or not taken as a director***
 - Director can be liable for negligent conduct as well as conduct amounting to willful, wanton, or gross negligence
 - Protects against claims of corporation, members, and third parties
 - Applies to monetary damages and equitable remedies

Statutory Immunity from Suit or Liability (continued):

- **33-31-202(b):** No director is *personally liable* for *monetary damages* for breach of any duty to the *nonprofit corporation or its members*, except:
 - (1) for any breach of the director's *duty of loyalty* to the corporation or its members,
 - (2) for acts or omissions *not in good faith* or which involve *intentional misconduct* or a *knowing violation of law*,
 - (3) for any transaction from which a director derived an *improper personal benefit*, or
 - (4) under Sections 33-31-831 (conflicts of interest), 33-31-832 (loans or guarantees for directors or officers), or 33-31-833 (liability for unlawful distributions).
- Protects against claims for negligence and gross negligence—i.e., requires intentional misconduct
 - Intentional means the specific intent to perform or fail to perform the act with actual knowledge that the specific action or failure to act will cause harm, rather than a general intent to perform acts which cause harm
- Applies to claims by corporation or members, but doesn't provide protection against claims of third parties
- Applies only to monetary damages, not equitable remedies

Statutory Immunity from Suit or Liability (continued):

- **33-31-834:** does *not* apply to KICA's board members because it covers directors of nonprofit that is *tax-exempt under IRC §501(c)(3), 501(c)(6), or 501(c)(12)*
 - *KICA is IRC §501(c)(4) entity, so not covered by this section*
- Immunity under this section is complete immunity for acts of negligence
 - However, immunity is removed when conduct amounts to *willful, wanton, or gross negligence*
- Protects against claims of corporation, members, and third parties
- Applies to monetary damages and equitable remedies

Business Judgment Rule:

- Rule means generally that a court will not review the judgment of the Board of Directors in furtherance of its business ***unless the Board acts outside the scope of its authority*** or with ***corrupt motives*** or in ***bad faith***
 - Rule designed to shield directors from litigation when reasonable minds can differ with regards to the best course of action for corporation
 - Directors not liable simply because unwise or unsuccessful (second-guessing improper)
- Protection of rule applies to actions taken **within the scope of corporation's powers** (*intra vires*), but not to acts beyond the scope of the corporation's powers (*ultra vires*)
- If corporate act in question is *intra vires*, party challenging act must show judgment of directors was product of ***bad faith, dishonesty, or incompetence***
 - Absence a showing of bad faith, dishonesty, or incompetence, judgment of the directors will not be set aside by judicial action
 - Burden of proving good faith is not on the governing board; instead, burden of proving lack of good faith is borne by those challenging board's actions
- ***Director must be disinterested*** to come under protection of rule

Board Member Rights:

- Within the bounds of reason, board members should feel free to contact the Board secretary, COO, or similar executive staff to obtain information needed to fulfill the director's duties
 - Requests generally should go through the Board chairperson, at board meetings, or pursuant to committee work rather than contacting lower-level staff directly
- A director generally has the right to inspect the association's books and records, although exceptions have been found to exist in certain circumstances
 - Such requests should be made so as not to disrupt normal business operations
- A director should be given ample notice of all board and committee meetings
- A director should be given copies of meeting minutes for board and committees exercising board powers after each meeting
- Under Art. V § 2 of KICA's bylaws, two or more directors or Chairperson may call or request special meetings of Board by giving at least 3 business days advance notice

Board Member Rights (continued):

- Under SCNPA, SC Code Ann. § 33-31-824, director may ***dissent from the holding of a board meeting*** for which the proper notice has not been given or other procedural requirements have not been satisfied
 - Director should state upon arriving or prior to voting on a matter that he/she objects because of noncompliance with notice or other applicable procedures
- Director has right to ***disagree with actions taken at board meetings and committee meetings***. Director may -
 - vote against action and have vote entered in meeting minutes
 - dissent or abstain from action and have that entered in meeting minutes
 - deliver written notice of dissent or abstention to presiding officer of meeting before its adjournment or to the association immediately after adjournment of meeting
 - Director may not dissent or abstain if he/she voted in favor of action taken at meeting
- If director does not object, vote against, dissent, or abstain, his/her presence at meeting is deemed to be waiver of notice and assent to action taken
- Director who voted against an action later found to be improper will not generally be subject to liability relating to the action

Board Member Rights (continued):

- Art. V § 10 of KICA's bylaws also establishes specific conditions for director to file a dissent
 - Director must advise entire Board in writing 2 business days after vote of intent to file dissent
 - Dissenting statement(s) shall be submitted to Secretary within 4 business days after vote
 - Any statement in support of vote shall also be provided to Secretary within 4 business days after vote
 - Secretary reviews statements for any "prohibited language" as defined in bylaws and then sends statements to entire Board for review
 - Final versions of dissenting and supporting statements submitted to Secretary within next 2 business days
 - Secretary also electronically sends final statements to all Members with explanation of substance of vote and that dissenting and supporting statements are being sent in connection with vote, but no further comments

Indemnification:

- Even if a director were found liable for an act or failure to act, the director may still have a right to indemnification from the corporation
 - Art. X § 2 of KICA's bylaws discusses indemnification of officers, directors, committee/task force members
- Under SCNPCA, , SC Code Ann. § 33-31-851, KICA **may** indemnify a director against liability incurred in a proceeding if the individual:
 - (1) conducted himself/herself in **good faith**; and
 - (2) **reasonably believed**:
 - (i) in the case of conduct in his/her **official capacity**, that his/her conduct was in **its best interests**; and
 - (ii) in **all other cases**, that his/her conduct was **not opposed to its best interests**; and
 - (3) in a **criminal proceeding**, had no **reasonable cause** to believe his/her conduct was unlawful.

Indemnification:

- The termination of a proceeding by judgment, order, settlement, conviction or upon a plea of nolo contendere or its equivalent is not, of itself, determinative that the director did not meet the required standard of conduct
 - Unsuccessful defense does not by itself preclude indemnification
- A corporation ***shall or must indemnify*** a director who was ***wholly successful***, on the merits or otherwise, in the defense of a proceeding to which the director was a party because he is or was a director of the corporation
 - This is ***mandatory*** indemnification
 - Indemnification covers “***reasonable expenses*** actually incurred” by the director in connection with the proceeding

Indemnification:

- A corporation *may not indemnify* a director:
 - (1) in connection with a proceeding by or in the right of the corporation in which the director was *adjudged liable to the corporation*; or
 - (2) in connection with any other *proceeding charging improper personal benefit to the director*, whether or not involving action in his official capacity, in which the director was *adjudged liable* on the basis that personal benefit was improperly received by the director.
- Art. X § 2 of KICA's bylaws further imposes obligation for KICA to indemnify a director for conduct involving mistake of judgment, negligent or otherwise, except for own individual *willful* misfeasance, malfeasance, misconduct, or *bad faith*
- This provision is not exclusive to any other indemnification rights a director would have

Liability Insurance:

- Insurance coverage is available to the organization for exposure to risks from the obligation to indemnify directors
- Nonprofit corporations commonly carry directors' and officers' liability insurance (D&O Coverage)
 - KICA has such a D&O policy
 - Generally protects directors/officers from having to personally fund expenses of litigation against the director/officer
 - Also covers any judgment against director/officer up to the insurance coverage limits
- Nonprofits generally find it prudent to offer the most coverage possible to recruit and protect skilled and competent directors
- Art. X § 2 of KICA's bylaws requires KICA to maintain general D&O insurance to assist in funding its indemnification obligations imposed under the bylaws