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THE NOT-SO-WELL-GOVERNED CHARITY

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I. OVERVIEW.

This outline is the “legal companion” to the excellent materials that Cynthia B. Nunn, President of the Center for Nonprofit Management, has prepared in connection with her remarks on the same topic. To ensure that the organization for which you labor is best described as *other than* a “Not-So-Well-Governed Charity,” it is important that you understand the legal framework within which charities and their managers must operate, and how various practices fall within or without the range of what is legally permissible and advisable. Parts II and III selectively discuss the general fiduciary duties imposed on directors of a Texas nonprofit corporation and on trustees of a charitable trust, respectively. Part IV briefly surveys federal tax laws and administrative policies that bear largely upon governance issues. Part V then discusses context-specific applications of the relevant legal rules previously discussed.

This outline employs the following abbreviations: (1) “TBOC” means the Texas Business Organizations Code; (2) “TTC” means the Texas Trust Code (codified in the Texas Property Code, sections of which are cited herein by referring to “TTC” sections); (3) “IRC” means the Internal Revenue Code of 1986, as amended; and (4) “IRS” means the Internal Revenue Service.

II. FIDUCIARY DUTIES GOVERNING DIRECTORS OF A NONPROFIT CORPORATION.

A. Duties of Directors and Standards for Discharging those Duties.

Traditionally, legal authorities state that directors of nonprofit corporations owe a duty of care and a duty of loyalty. Texas has largely codified and statutorily expounded upon these duties. This section of the outline discusses the statutory articulation of the duties of loyalty and care, as well as authorities that bear upon whether, and (if so), in what sense, directors may owe yet another duty – a “duty of obedience.”

This outline addresses the relevant rules selectively, so it should not be relied upon as a comprehensive primer on fiduciary duties. For example, this outline does not discuss in any significant detail the Texas version of the Uniform Prudent Management of Institutional Funds Act (“TUPMIFA”). For additional (and broader) commentary on fiduciary duties under Texas law, see Johnny Rex Buckles, *Fiduciary Duties 101 for Charity Managers and their Legal Counsel*, 40 THE TEXAS TAX LAWYER (Spring 2013). (Sections II and III of this outline borrow heavily from this article.)

1. In General.

A director must discharge his or her duties (1) in good faith, (2) with ordinary care, and (3) in a manner the director reasonably believes to be in the best interest of the corporation. TBOC § 22.221(a). These standards apply to a director’s service both on the governing board and on a committee. *See id.* Prongs (2) and (3) essentially impose on directors the duty of care and the duty of loyalty, respectively. Prong

(1)'s requirement of "good faith" is perhaps best conceptualized as an element of both loyalty and care. *See, e.g.,* PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS (Tentative Draft no. 1, March 19, 2007) § 300, cmt. g(1) (hereinafter "PLNO").

a. Meaning of Good Faith.

Two non-binding sources inform the meaning of good faith. One is the Revised Model Nonprofit Corporation Act, which contains many provisions highly similar to those adopted by the Texas legislature in the TBOC. The official comment to section 8.30 of the Revised Model Nonprofit Corporation Act, which also requires good faith of directors, characterizes the requirement of good faith as a "precondition" to the discharge of duties as a director. It further states that a court "will look to the director's state of mind to see if it evidenced honesty and faithfulness to the director's duties and obligations."

PLNO offers another useful perspective on good faith. Under PLNO, a failure to act in good faith includes conscious disregard of the charitable organization's best interests, "including intentionally abdicating the duty of care." PLNO § 300, cmt. g(1). Further, a director acting in good faith should "disclose to other board members nonconfidential material information that they do not already possess." *Id.* § 300, cmt. g(2).

b. Meaning of Ordinary Care.

"Ordinary care" means the care that an ordinarily prudent person in a similar position would exercise under similar circumstances. TBOC § 22.001(6).

c. Meaning of Reasonable Belief in Best Interest of the Corporation.

The requirement that a director act in a manner that the director reasonably believes to be in the corporation's best interest means that a director must put no other interest ahead of the corporation's interest, whether that competing interest is that of the director or that of a third person.

2. Reliance on Other Persons.

a. Reliance on Others with Special Expertise or Knowledge: In General.

In discharging a duty or exercising a power, a member of the board of directors generally may rely on information, opinions, reports, or statements (including financial statements and other financial data) prepared or

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