

To: Wisconsin Balance of State Continuum of Care, Inc.

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Subject: Duties of nonprofit directors
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This memorandum provides a general overview of the fiduciary duties of directors of a nonstock corporation under Chapter 181 of the Wisconsin Statutes. There are two key fiduciary duties of a director of a nonstock corporation set forth in Chapter 181 of the Wisconsin Statutes: (1) the duty of loyalty, and (2) the duty of care. The broad outlines of these duties are set forth in Chapter 181 with case law expounding on these duties.

In basic terms, the duty of loyalty requires a director to put the interests of the corporation above the interests of the director personally or any third-party organization with whom the director may be affiliated. It also prohibits the director from making any decision or entering into any transaction for which the director will personally profit. If a director was appointed to the Board to represent a specific interested party, that director nonetheless has a duty to act in the best interests of the corporation as a whole, rather than to advocate for that interested party.

The duty of care is typically described as a director's duty to act with good faith and with the care that an ordinarily prudent person would exercise in a like position under similar circumstances.

Background

Nonstock corporations are governed under Chapter 181 of the Wisconsin Statutes. This chapter of the statutes was completely restated in 1998 with a key objective being to mirror the provisions of Chapter 180, governing for-profit business corporations, to the extent appropriate. See Garth Seehawer, The New Nonstock Corporation Law, WISCONSIN LAWYER, October 1998, at 10, 12. This was consistent with the Model Nonprofit Corporation Act (MNCA), upon which the Act was based, whose drafters¹ similarly chose to mirror the Model Business Corporation Act, unless the nature of the nonprofit corporation or public policy reasons dictated otherwise.²

¹ Business Law Section of the American Bar Association.

² Model Nonprofit Corporation Act, 1 Religious Organizations and the Law § 9:11.

Because of the purposeful similarity between Chapter 181 and Chapter 180, cases interpreting Chapter 180 are a useful source of guidance when interpreting the duties of directors of non-stock corporations under Chapter 181. In this regard, it is important to note that the Wisconsin Court of Appeals has held that the duties of directors in a business corporation and nonstock corporation are the same stating: “. . . in the area of directors’ obligations to the corporation and its members or stockholders, the differences between stock and nonstock corporations have no bearing; the same relationship of trust and confidence exists.” O’Leary v. Bd. of Directors, Howard Young Med. Ctr., Inc., 89 Wis. 2d 156, 168, 278 N.W.2d 217, 221 (Ct. App. 1979).

The following sections will discuss the duty of loyalty, the duty of care, a closely associated rule called the “business judgment rule,” and to whom these duties are owed.

Duty of Loyalty

A. Statutes

The Wisconsin Statutes do not explicitly define loyalty but rather set forth several sections outlining how a director may violate the duty of loyalty. The most relevant to the Wisconsin Balance of State Continuum of Care, is Wis. Stat. § 181.0831, which outlines when a transaction entered into between the corporation and a director may be voidable due to a conflict of interest:

(1) No contract or other transaction between a corporation and a director, or any entity in which a director is a director or officer or has a material financial interest, is void or voidable because of the relationship or interest or because the director is present at the meeting of the board or a committee that authorizes, approves or ratifies the contract or transaction or because the director’s vote is counted for that purpose, if any of the following applies:

(a) The relationship or interest is disclosed or known to the board or committee that authorizes, approves or ratifies the contract or transaction and the contract or transaction was authorized, approved or ratified by a vote or consent sufficient for the purpose without counting the votes or consents of interested directors.

(b) The fact of such relationship or interest is disclosed or known to the members entitled to vote and they authorize, approve or ratify that contract or transaction by vote or written consent.

(c) The contract or transaction is fair and reasonable to the corporation.

....

It is important to note that the articles of incorporation, the bylaws or a resolution of the Board may impose additional requirements on conflict of interest transactions.

Two other sections outlined in the statutes related to the duty of loyalty are Wis. Stat. § 181.0832, which puts limitations on when a corporation can make a loan or guarantee the

obligation of a director, and Wis. Stat. § 181.0833, which sets forth a director's personal liability if the director approves an unlawful distribution from the corporation.

Wis. Stat. § 181.0810 includes provisions outlining when a Court may remove a director for various breeches including upon a finding that the director has violated a fiduciary duty or a duty under §§ 181.0831 to 181.0833 [conflict of interest, improper loan or guarantee and director's approval of unauthorized distribution, respectively] or that the removal is in the best interest of the corporation.

B. Case Law

Compliance with the fiduciary duty of loyalty requires that a director put the interests of the corporation and its shareholders above his or her own personal interests. See, e.g., Rose v. Schantz, 56 Wis.2d 222, 228, 201 N.W.2d 593, 597 (1972); Jorgensen v. Water Works, Inc., 2001 WI App. 135, ¶ 10, 246 Wis. 2d 614, 630 N.W.2d 230 (Ct. App. 2001). If a director has a conflict of interest associated with a particular decision or transaction submitted for Board approval, the director must fully disclose all aspects of that conflict to the Board, and the director's best course of action is to abstain from voting on such matter.

It is important that independent-minded directors control the Board's decision-making processes. No director, officer or shareholder should be allowed to dominate or unduly influence a director with respect to a business decision. Each director should take steps to ensure an independent recommendation from the Board and prevent even the appearance of a lack of independence.

A "constituency director" (also known as a "representative director" or "designated director") is a director designated to the Board by a particular constituency (or "sponsor"). These constituency directors are generally appointed to advocate for a particular interested party that is not a common shareholder or investor, such as preferred shareholders or creditors. See Simone M. Sepe, Intruders in the Boardroom: The Case of Constituency Directors, 91 WASH. U.L. REV. 309 (2013). Constituency directors can generally provide their sponsors with a voice in the boardroom but they should not expect to be their sponsors' eyes and ears. Constituency directors may breach their fiduciary duty of loyalty by transmitting confidential corporate information to their sponsors despite any contractual expectations to the contrary. See Norman Veasey and Christine T. Di Guglielmo, How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors, THE BUSINESS LAWYER, VOL. 63, May 2008, at 775. Further, "the duty of undivided loyalty to shareholders may prevent constituency directors from taking actions to the exclusive benefit of the designating investors." See Sepe, at 345. A constituency director's conduct is held to the same standard as a non-constituency director, that being the best interest of the corporation as a whole, not what is in the best interests of the constituency director's sponsor. See Beam v. Stewart, 845 A.2d 1040, 1049 (Del. 2004).

It should be noted that under Wis. Stat. § 181.0853, "[i]n discharging his or her duties to the corporation and in determining what he or she believes to be in the best interests of the corporation, a director or officer may, in addition to considering the effects of any action on members (as a group), as well as consider the effects of the action on employees, suppliers, and customers of the corporation, the effects of the action on communities in which the corporation operates, and any other factors that the director or officer considers pertinent."

The provisions of Wis. Stat. § 181.0853 permit a director to consider these other factors, but do not create new fiduciary obligations requiring the directors to consider such other interests. Directors who favor another constituency over its shareholders may violate their duty of loyalty. See, e.g. Revlon, Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173, 182 (Del. 1986) (holding that the Board breached duty of loyalty by entering into a lockup agreement on the basis of impermissible considerations of the noteholders' interests at the expense of the shareholders).

Duty of Care

A. Statutes

There is no statute that generally states that a director has a duty of care to the corporation. However, Wis. Stat. § 181.0853 outlines what interests a director may consider, in addition to considering the best interests of the corporation:

In discharging his or her duties to the corporation and in determining what he or she believes to be in the best interests of the corporation, a director or officer may, in addition to considering the effects of any action on members, consider the following:

- (1) Employees, suppliers and customers. The effects of the action on employees, suppliers and customers of the corporation.
- (2) Communities. The effects of the action on communities in which the corporation operates.
- (3) Other. Any other factors that the director or officer considers pertinent.

(emphasis added).

B. Case law

The duty of care is typically described as a director's duty to act with good faith, with the care that an ordinarily prudent person would exercise in a like position under similar circumstances, and in a manner reasonably believed to be in the best interests of the corporation. In Wisconsin, the duty of care requires a director to act with a degree of care that an ordinarily prudent person would exercise in a like position under similar circumstances. See Johnson v. Stoughton Wagon Co., 118 Wis. 438, 95 N.W. 394, 397 (1903). In making a determination as to whether a director acted in accordance with his or her duty of care, the court will typically examine: (i) the director's responsibility in a particular corporation; (ii) the information available to the director at the time of action; and (iii) the special background knowledge or expertise of the director.

A director's compliance with his or her fiduciary duty of care requires that decisions be made on a fully informed basis, including:

- Making reasonable inquiries, actively obtaining all material facts reasonably available and pursuing all reasonably available sources of information or knowledge to make an informed decision.

- Making further independent inquiry when your particular knowledge or experience warrant.
- Not closing one's eyes to red-flags (ignorance is not bliss).
- Performing independent homework or due diligence in connection with important decisions:
 - a. Reading, in advance of meetings, all background materials and documents that will be subject to Board approval.
 - b. Asking for and receiving, in advance of meetings, summary reports from professionals to explain the intent, content, implications and risks associated with each material document/action that will be subject to Board approval.
 - c. Asking pertinent questions and receiving satisfactory answers from competent sources.

In satisfying a director's duty of care, he or she may rely on the advice and reports of experts (*i.e.*, attorneys, accountants, financial advisers and appraisers), provided that the subject matter is within the expert's area of expertise and the expert is fully informed. A director may also rely on the advice and reports of officers or directors most familiar with the subject matter, if the director believes, in good faith, that such officer or director is reliable and competent in such matters. Similarly, a director may rely on the advice and reports of Board committees, if any, if the director believes it is reasonable to do so and such committees merit confidence. In any case, reliance on the advice of another is not warranted when the director has personal knowledge of facts or circumstances which make such reliance unwarranted.

The standard of care applies to the decision-making process itself, not to the Board's ultimate decision. The Board can make a decision which, in hindsight, was a bad one, provided that it was a fully informed decision made in the good faith belief that it was in the best interests of the corporation and its shareholders.

Business Judgment Rule

Closely tied to the duties set forth above, the business judgment rule is a judicially created doctrine that acts as a defense to corporate officers and directors, limiting their liability for corporate management decisions made in good faith. "The business judgment rule is a defense; if directors act loyally and carefully, they are not liable even if the transaction goes awry." Alliant Energy Corporation v. Brie, 277 F. 3d 916, 918 (7th Cir. 2002). By definition, a decision is not shielded by the business judgment rule when the decision was not made in good faith or was not made in the best interests of the company. The business judgment rule is applicable to both Business Corporations and Nonstock Corporations. See John H. Warren III, Liability for Directors of Nonprofit Corporations, THE NATIONAL LAW REVIEW, March 20, 2017.

Wisconsin courts have long recognized and applied the business judgment rule in cases involving corporate decision making. In explaining the business judgment rule and its application to corporate decision making, the Wisconsin Court of Appeals has stated:

The business judgment rule is a judicially created doctrine that contributes to judicial economy by limiting court involvement in business decisions where courts have no expertise and contributes to encouraging qualified people to serve as directors by ensuring that honest errors of judgment will not subject them to personal liability.

Reget v. Paige, 2001 WI App 73, ¶ 17, 242 Wis. 2d 278, 293, 626 N.W.2d 302, 310.

Further, the Wisconsin Supreme Court has stated:

This court will not substitute its judgment for that of the board of directors and assume to appraise the wisdom of any corporate action. The business of a corporation is committed to its officers and directors, and if their actions are consistent with the exercise of honest discretion, the management of the corporation cannot be assumed by the court.

Steven v. Hale-Haas Corp., 249 Wis. 205, 221, 23 N.W. 2d 620, 628 (1946). See also Reget, 242 Wis. 2d at 293; Einhorn v. Culea, 2000 WI 65, ¶ 19, 235 Wis. 2d 646, 656, 612 N.W. 2d 78, 84 (stating the business judgment rule “shields, to a large extent, the substantive basis for a corporate decision from judicial inquiry” and “ensures the management remains in the hands of the board of directors and protects courts from becoming too deeply implicated in internal corporate matters”).

Where the business judgment rule applies, the burden of proof is on the plaintiff to show that the defendant director acted fraudulently or with bad faith thereby rendering the protections of the business judgment rule inapplicable. The business judgment rule will not, however, shield an individual director from personal liability if he or she acted with improper motive. See Sprecher v. Weston’s Bar, Inc., 78 Wis. 2d 26, 40, 253 N.W.2d 493, 499 (1977); Mendelson v. Blatz Brewing Co., 9 Wis. 2d 487, 492-93, 101 N.W.2d 805, 807-08 (1960).

The Wisconsin Nonstock Corporation Law essentially incorporates the standards of the business judgment rule by specifically limiting the liability of directors for most actions taken in good faith. Wis. Stat. Ann. § 181.0855 provides for limited liability of directors and officers who act in good faith:

(1) In general. Except as provided in subs. (2) and (3), a director or officer is not liable to the corporation, its members or creditors, or any person asserting rights on behalf of the corporation, its members or creditors, or any other person, for damages, settlements, fees, fines, penalties or other monetary liabilities arising from a breach of, or failure to perform, any duty resulting solely from his or her status as a director or officer, unless the person asserting liability proves that the breach or failure to perform constitutes any of the following:

(a) A willful failure to deal fairly with the corporation or its members in connection with a matter in which the director or officer has a material conflict of interest.

(b) A violation of criminal law, unless the director or officer had reasonable cause to believe that his or her conduct was lawful or no reasonable cause to believe that his or her conduct was unlawful.

(c) A transaction from which the director or officer derived an improper personal profit or benefit.

(d) Willful misconduct.

To Whom Duties Owed

One final consideration is to whom directors owe such duties. The statutes and cases are clear that directors owe the duties to the corporation. Directors will generally be responsible for protecting the best interests of the corporation, even if the director is a constituency director. See Veasey and Di Guglielmo at 774. The statutes provide that in addition to considering the interests of the corporation, a director may also consider the effects of an action on employees, suppliers, and customers of the corporation, on communities in which the corporation operates, and any other factors that the director or officer considers pertinent. Wis. Stat. § 181.0853. However, this statute does not result in a director having a duty to such outside interests. While a director, in considering the best interests of the corporation, will surely consider the underlying beneficiaries of the corporation (i.e. a director of the Wisconsin Balance of State Continuum of Care, Inc., will consider how his or her decision will affect the homeless population), the director's duty does not extend to the beneficiaries of the charitable purpose, such as grant donees. See Warren.