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THE NONPROFIT CORPORATION ACT OF 1993: CONSIDERING THE ELECTION TO APPLY THE NEW LAW TO OLD CORPORATIONS

James Edward Harris*

The Arkansas Nonprofit Corporation Act of 1993 (hereinafter the “Act”) creates a comprehensive corporate code which applies to all Arkansas nonprofit corporations incorporated after 1993. Nonprofits chartered before 1994 may elect to become subject to the provisions of the Act by amending their articles of incorporation after December 31, 1993. The Act addresses many questions which are unanswered by the existing statutes, provides clear and complete rules for corporate governance and action, and establishes modern standards of conduct for directors and officers. These substantial advantages will lead most existing nonprofits to consider opting to be governed by the Act. This article will describe principal features of the Act and will analyze the factors which favor making the election. Essential to any consideration of electing under the new law is an understanding of the deficiencies of the old statutes. Thus, a preliminary discussion of the development of this legislation may be helpful.

I. HISTORY OF LEGISLATIVE PROJECT

The old law was enacted thirty years ago, in a day when nonprofit corporations in our state were limited in number and complexity. Today there are many more such entities in existence, and the percentage of corporations which are nonprofits has increased dramatically. Of the approximately 100,000 corporations on file with

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* The author and Greg Graham served as co-Chairmen of the Arkansas Bar Association Tax Section Committee which developed the legislative proposal for the Nonprofit Corporation Act of 1993. The other members of the committee were Steve Bauman, Joe Hickey, Wilson Jones, John Lessel, Tom Overbey and Obert Undhem, all of whom contributed greatly to that effort.

3. Id. § 4-33-1701.
5. In a broad sense, there are probably more nonprofit than business organizations in United States today. Howard L. Oleck, Nonprofit Corporations, Organizations, and Associations, § 1 (5th ed. 1988).
the Arkansas Secretary of State, a surprising 30,000 of them are nonprofits. Some of them, most notably hospitals, universities and other major charities, have complicated organizational structures and operations with very large budgets, which rival those of major business corporations. In this environment there was a widespread perception among attorneys who counsel nonprofits that our existing law was woefully inadequate. Indeed, legal scholars have described old nonprofit corporation laws around the country as existing in "a remarkably immature stage of development." The old law in Arkansas had been amended several times to remedy specific problems, but the need was apparent for a complete and modern code versus a continued patchwork of repairs. As Chairman of the Tax Section in 1990-1991, Joe Erwin surveyed the section membership about this problem, and the strong response led him to form a committee charged with drafting a bar-sponsored legislative proposal (hereinafter the "Committee").

A few examples of important deficiencies in the old law include the following: provisions for the conduct of members' and directors' meetings were sketchy; no statutory authority existed for action by consent without a meeting; the law allowed amendments to the articles but gave no guidance on how amendments were to be approved by the corporation; no procedures were prescribed for approval of extraordinary transactions involving voluntary dissolution or sale of substantially all the corporation's assets; there were no statutory standards for measuring the duties of care and loyalty owed by directors and officers; clear authority for the indemnification of officers and directors was lacking.

6. Telephone Interview with Jim Werner, Secretary of State Staff Attorney (December 16, 1993).
7. The annual revenues of nonprofits nationally have been estimated at nearly $500 billion. Id.
9. 1983 Ark. Acts 614 (codified at ARK. CODE ANN. §§ 4-28-301 to -309 (Michie 1987) (providing a statutory scheme for the merger of nonprofit corporations); see 1989 Ark. Acts 672 (adding two enhancements: authority for voting by proxy (codified at ARK. CODE. ANN. § 4-28-212(c) (Michie 1987)), and adding rules for the corporation's acceptance of votes similar to those in the ABCA (Id. § 4-28-224)).
10. ARK. CODE ANN. § 4-28-206(d) (Michie 1987).
The Revised Model Nonprofit Corporation Act (hereinafter "RMNCA"), developed under the auspices of the American Bar Association, addresses those and many other concerns. In addition, the model act is similar in its organization and its coverage of comparable corporate issues to the Revised Model Business Corporation Act, the basis for the Arkansas Business Corporation Act of 1987 (hereinafter "ABCA"). The Committee believed similarity between the RMNCA and ABCA would be viewed favorably by our legislature and would contribute to familiarity and ease of use by attorneys. Our neighbors in Tennessee and Mississippi had substantially adopted the RMNCA after it was published as an exposure draft. Accordingly, when the Committee began its work on the new Arkansas law, the RMNCA provided a natural blueprint.

Many differences exist, however, between the 1993 Arkansas Act and the RMNCA. The substantial modifications reflect the desired goal of designing a law which aligns our state's laws and practices appropriately and which our legislature would likely favor. It is beyond the scope of this article to describe all of the alterations, but the provisions which concern recording and reporting requirements provide a good example. An entire chapter of the RMNCA is devoted to the requirements for maintaining corporate records and for filing reports with the Secretary of State. One of the guiding policies of the Committee was to secure the advantages of a modern corporate code without unduly increasing the regulatory burden on nonprofits. A great number of nonprofit corporations are small organizations which would have difficulty complying with increased requirements for filing forms with a government agency if the regulatory burden were increased. Nevertheless, a majority of the Committee believed that the law should require filing a simple annual report to confirm the corporation's continued existence and current information regarding its registered agent and address. However, even that simple requirement was objectionable to some legislators; thus, it was eliminated from the Act.

13. Therefore, the Official Comments to the model act are very helpful to an understanding of the Arkansas law. REVISED MODEL NONPROFIT CORP. ACT, official text with official comments and statutory cross-references, Michael C. Hone, Reporter (Prentice-Hall 1988).
II. KEY FEATURES OF THE NEW ACT

A. Classification of Corporations under the Act

A central feature of RMNCA, which was included in the Arkansas Act, is the establishment of three categories of nonprofit corporations: public benefit corporations, mutual benefit corporations, and religious corporations. Somewhat different rules and procedures apply to each corporate type. The Act does not define permitted purposes for each category, but the incorporators must choose which kind is most appropriate and then abide by the prescribed set of rules. Thus, the articles of incorporation contain a statement which declares the type of corporation being formed.15

Choosing the appropriate corporate type is not as complicated as it initially may seem. Most organizations will fit naturally into only one of the three categories. The requirements for qualification under the applicable federal tax exemption will further influence the choice. For example, a corporation desiring exemption under section 501(c)(3) of the Internal Revenue Code must be either a public benefit or religious corporation. Social welfare organizations normally will be public benefit corporations under Internal Revenue Code section 501(c)(4). Trade associations and chambers of commerce, exempt under the Internal Revenue Code section 501(c)(6), will declare the mutual benefit category, as will recreational membership clubs, exempt under Internal Revenue Code section 501(c)(6), (7).

The choice of category is further simplified because under the Act few differences exist concerning the rules which apply to the three kinds of corporations, even fewer differences in fact than those contained in the RMNCA. For example, in the procedure for approval of conflict of interest transactions, the new Act does not include the additional requirement that directors of a public benefit or religious corporation must in good faith believe that the transaction is fair to the corporation.16 Instead, in all cases, to validate a conflict of interest transaction, the Act requires that under the circumstances, the transaction was in fact fair to the corporation at the time it was entered into.17

Existing corporations electing to become subject to the Act do not have a choice; the applicable category is determined by set rules.18 Any corporation organized primarily or exclusively for religious

18. Id. § 4-33-1707.
purposes is a religious corporation. Those corporations other than religious which are recognized as exempt under Internal Revenue Code section 501(c)(3) are public benefit corporations. A corporation which does not fit within those rules, but which nevertheless is organized for a public or charitable purpose, and which upon dissolution must distribute its assets to public benefit corporations or Internal Revenue Code section 501(c)(3) entities, is also a public benefit corporation. Finally, if none of those rules fit, the corporation is a mutual benefit corporation.

Most of the major differences in the rules arise from the premise that members of mutual benefit corporations can have an economic interest in the corporation, while members of public benefit or religious corporations cannot. For this reason, an exception to the general rule which prohibits distributions, allows a mutual benefit corporation to make distributions in redemption of its memberships, so long as those distributions do not render the corporation insolvent. Concomitantly, a mutual benefit corporation, upon dissolution, may distribute its assets to its members, while all other corporations must transfer them to other public benefit or religious corporations.

The Act also contains certain limitations upon mergers; these limitations apply exclusively to public benefit or religious corporations. A public benefit or religious corporation can merge with a mutual benefit corporation only if the public benefit or religious corporation is the survivor and continues to be a public benefit or religious corporation after the merger, unless the chancery court grants prior approval. In addition, unless the chancery court authorizes an exception, members of a public benefit or religious corporation may not receive corporate assets as a result of a merger, other than membership in the surviving public benefit or religious corporation.

The procedures for amending the articles and bylaws illustrate another difference that satisfies the members' economic interests in mutual benefit corporations. The articles of a public benefit or religious corporation may be amended by the directors without a vote of the members, so long as the amendments do not alter the

19. Id. § 4-33-1302. Similarly, there is an exception to the general rule against transfers of memberships, which permits the articles or bylaws of a mutual benefit corporation to authorize such transfers. Id. § 4-33-611.

20. Id. § 4-33-1406(a)(6), (7). If the dissolving corporation is described in section 501(c)(3) of the Internal Revenue Code, there is a further restriction that the assets may be transferred only to other section 501(c)(3) organizations. I.R.C. § 501(c)(3) (West Supp. 1993).


22. Id. § 4-33-1102(b).
number, composition, term, or election of the directors.\textsuperscript{23} For mutual benefit corporations, the members must approve amendments to the articles by a two-thirds vote or a majority of the voting power, whichever is less.\textsuperscript{24} The same rules apply to bylaw amendments.\textsuperscript{25}

As the foregoing discussion indicates, the treatment of public benefit and religious corporations under the Act is very similar. The differences that do exist recognize the constitutional constraints upon the state’s regulation of religion. Indeed, the Act expressly declares constitutional protection for religious corporations:

If religious doctrine governing the affairs of a religious corporation is inconsistent with the provisions of this chapter on the same subject, the religious doctrine shall control to the extent required by the Constitution of the United States or the constitution of this state or both.\textsuperscript{26}

Although the RMNCA is the source of this provision, the provision comports with the ruling of the Arkansas Supreme Court in \textit{Gipson v. Brown}.\textsuperscript{27} \textit{Gipson} held that under the First and Fourteenth Amendments of the United States Constitution and the Constitution of Arkansas,\textsuperscript{28} an incorporated church’s denominational doctrine, which provided that governance should vest solely in the elders, must prevail over the conflicting statute which gave members the right to inspect corporate records. The chancery court’s attempt to apply the old Arkansas Nonprofit Corporation Act was an unconstitutional interference with the free exercise of religion, absent a showing of a compelling state interest.\textsuperscript{29}

A recent development in this area is the Religious Freedom Restoration Act of 1993, by which Congress reinstated the “compelling interest” test in response to \textit{Employment Division v. Smith}.\textsuperscript{30} In furtherance of its religious liberty policy, the new Act makes some of its provisions inapplicable to religious corporations. For example, the procedures for termination, expulsion, and suspension of members

\begin{itemize}
  \item \textsuperscript{23} \textit{Id.} $\S$ 4-33-1003(a)(1).
  \item \textsuperscript{24} \textit{Id.} $\S$ 4-33-1003(a)(2).
  \item \textsuperscript{25} \textit{Id.} $\S$ 4-33-1021.
  \item \textsuperscript{26} \textit{Id.} $\S$ 4-33-180.
  \item \textsuperscript{27} 295 Ark. 371, 749 S.W.2d 297 (1988).
  \item \textsuperscript{28} \textsc{Ark. Const.}, art. 2, $\S\S$ 24-25.
  \item \textsuperscript{30} 494 U.S. 872 (1990).
\end{itemize}
apply only to public and mutual benefit corporations.\textsuperscript{31} Other provisions specifically permit a religious corporation's articles or bylaws to restrict or eliminate their application. Examples include the provisions regarding members' rights to inspect membership lists\textsuperscript{32} and to compel a special meeting with only five percent of the voting power,\textsuperscript{33} and the procedures for removal of directors\textsuperscript{34} and for judicial dissolution.\textsuperscript{35}

B. Judicial Supervision

Another key distinction between the old and new acts is the forum for judicial supervision of nonprofit corporations. To incorporate under the old law, the articles were first filed with the circuit court in the county where the principal office was located, and then the articles, accompanied by a court order approving the incorporation, were filed with the Secretary of State.\textsuperscript{36} Although there is scant authority on the subject, the circuit court's participation in the creation of a nonprofit raised questions concerning its continuing jurisdiction over the corporation, at least with respect to matters such as amending the articles and corporate dissolution.\textsuperscript{37} Those questions will persist for old corporations which do not elect governance by the new Act.

Although the new rules do not require the articles to be filed or approved by the court, there are a number of circumstances in which the Act provides for judicial intervention.\textsuperscript{38} In each instance

\begin{quote}
\textsuperscript{31}. \textsc{Ark. Code Ann.} § 4-33-621 (Michie Supp. 1993).
\textsuperscript{32}. \textit{Id.} § 4-33-720.
\textsuperscript{33}. \textit{Id.} § 4-33-702(a)(2).
\textsuperscript{34}. \textit{Id.} § 4-33-808.
\textsuperscript{35}. \textit{Id.} § 4-33-1430.
\textsuperscript{36}. \textit{Id.} § 4-28-206 (Michie 1991).
\textsuperscript{37}. In an injunction proceeding by one nonprofit corporation against a nonprofit association, the chancery court was held to have proper jurisdiction because the injunctive relief being sought was an equitable remedy. \textit{Fort Smith Symphony Orchestra, Inc. v. Fort Smith Symphony Ass'n}, 285 \textit{Ark.} 284, 686 S.W.2d 418 (1985).
\textsuperscript{38}. Examples of such judicial actions include: ordering the manner of conducting a meeting or vote which is impossible or impractical to conduct otherwise (\textsc{Ark. Code Ann.} § 4-33-160 (Michie Supp. 1993)); ordering a meeting to be held upon application of a member when the corporation has failed to hold a meeting in due course. (\textit{Id.} § 4-33-703); removing a director upon a finding of fraudulent or dishonest conduct, gross abuse of authority or discretion, or a final judgment determining the director has violated a statutory duty (\textit{Id.} § 4-33-810); dissolving a corporation (\textit{Id.} § 4-33-1430); and hearing an appeal (in Pulaski County Chancery Court) from the Secretary of State's revocation of a foreign corporation's certificate of authority (\textit{Id.} § 4-33-1532).
\end{quote}
the judicial role is assigned to the chancery courts. Traditional common-law principles confer upon chancery the inherent and exclusive jurisdiction over charitable as well as private trusts. Thus, the Committee believed that the chancery courts would provide the most appropriate forum for dealing with nonprofit corporation issues.

C. Meetings and Action Without Meetings

1. Action Without Meetings

A significant advantage of the new Act is that the members and directors possess the authority to take action by written consent without a meeting. Although directors may have acted in this manner previously, no statutory authority existed for acting without a meeting under the old law. Unless the articles or bylaws provide otherwise, the new Act permits the directors to take any action which could be taken at a board meeting by drafting one or more written consents which describe the action, contain the signatures of all directors, and are included in the minutes filed with the corporate records which reflect the action taken. A consent has the same effect as a meeting vote and may be described as such in any document. An action taken in this manner is effective when the last director signs the consent, unless the consent specifies a different effective date. To facilitate rapid written action by directors, the statute makes valid a consent which is delivered by facsimile transmittal.

A similar provision allows the members to act without a meeting if an action is approved by written consent from members holding at least eighty percent of the voting power. If approval is not obtained from all members, however, the action is not effective until ten days after the nonconsenting members receive written notice of the action.

The members also have the alternative of taking action by written ballot. This form of action is valid only when the number of votes cast by ballot, and the number of approvals obtained, at least equals the quorum and affirmative vote that would be required to approve the action if it were taken at a meeting. Additionally, solicitations for votes by written ballots must include the following information: the number of ballots needed to meet the quorum requirement; the percentage of approvals necessary to approve each matter (except election of directors); and the date by which the ballot must be received to be counted.

2. Administrative Requirements for Meetings of Members

Except for the sketchy provision on voting, the old law neither imposed requirements nor provided guidance on the conduct of members' meetings. In contrast, the new Act contains very detailed procedures that must be followed in calling and conducting meetings. In considering whether to be governed by the new Act, the members and directors of an existing corporation need to be familiar with these requirements and determine to abide by them.

Generally, a corporation must give notice of meetings, consistent with its bylaws, in a fair and reasonable manner; to avoid any question, however, notice of all annual, regular, and special meetings should comply with a statutory safe harbor. That standard is met when notice is mailed first class no fewer than ten days, nor more than sixty days before the meeting date. The safe harbor provides that notice of any special meeting must give the reason for which the meeting is called; even notice of annual or regular meetings must describe certain extraordinary items for which member approval is required by statute. A member may waive the notice requirement either in writing or by his attendance at a meeting.

At times, neither the bylaws nor the board of directors fix a record date to determine the members who are entitled to notice and to vote. When no record date is declared, then the default record date for notice is the day before notice is given; additionally, the default record date for voting is the date of the meeting.

48. Id. § 4-33-708.
49. Id. § 4-33-708(c).
50. Id. § 4-33-708(d)(1)-(3).
51. Id. § 4-28-212 (Michie 1991).
52. Id. § 4-33-705 (Michie Supp. 1993).
53. Id. § 4-33-705(c)(1).
54. Id. § 4-33-705(c)(2), (3).
55. Id. § 4-33-706.
56. Id. § 4-33-707.
After fixing a record date, the corporation must prepare an alphabetical list of all members entitled to notice of the meeting; the list must show the address and number of votes each member is entitled to cast.\textsuperscript{57} The list of members entitled to vote must be updated through the time of the meeting.\textsuperscript{58} The list must be available for inspection by any member, or member’s attorney or agent, before and at the meeting.\textsuperscript{59} However, the statute places protections upon the list by prohibiting its unauthorized use for any commercial purpose, for soliciting money (except to seek votes in an election to be held by the corporation), or for any other purpose unrelated to a member's interest as a member.\textsuperscript{60}

In conducting a member vote, the default quorum requirement is ten percent, but the articles or bylaws can provide for a higher or lower quorum.\textsuperscript{61} However, a quorum of one-third of the voting power is required at an annual or regular meeting for any matter not disclosed in the notice.\textsuperscript{62} If a quorum is present, the members can act by the affirmative vote of a majority unless the articles or bylaws, or special provisions of the new Act, require a greater vote or require voting by class.\textsuperscript{63} Unless the articles or bylaws provide otherwise, each member is entitled to one vote, except that a member holding more than one membership has one vote for each membership, as under the old law.\textsuperscript{64} Like the amended old law, the new Act contains a set of rules for proxy voting, but the articles or bylaws can prohibit or limit that type of vote.\textsuperscript{65} There is also a counterpart to a voting trust provision which allows members to execute an agreement to vote in a certain manner.\textsuperscript{66} Such agreements are valid for up to ten years and are specifically enforceable.\textsuperscript{67}

In the election of directors, the articles or bylaws can provide for cumulative voting by members.\textsuperscript{68} To authorize such voting at any particular meeting, however, the meeting notice must state that cumulative voting will occur, and at least one member must give notice at the meeting that he intends to cumulate votes.\textsuperscript{69} Alternative

\begin{itemize}
\item \textsuperscript{57} Id. § 4-33-720(a).
\item \textsuperscript{58} Id. § 4-33-720(a).
\item \textsuperscript{59} Id. § 4-33-720(b).
\item \textsuperscript{60} Id. § 4-33-720(d)(1), (2).
\item \textsuperscript{61} Id. § 4-33-722(a).
\item \textsuperscript{62} Id. § 4-33-722(d).
\item \textsuperscript{63} Id. § 4-33-723(a).
\item \textsuperscript{64} Id. § 4-33-721(a).
\item \textsuperscript{65} Id. § 4-33-724(a).
\item \textsuperscript{66} Id. § 4-33-730.
\item \textsuperscript{67} Id. § 4-33-730.
\item \textsuperscript{68} Id. § 4-33-725.
\item \textsuperscript{69} Id. § 4-33-725(b)(1), (2).
\end{itemize}
methods of electing directors are allowed, including election by chapter or region, by preferential voting, or by any other reasonable method.\textsuperscript{70}

3. \textit{Meetings of Directors}

The rules for directors' meetings are simple and analogous to the provisions of the ABCA. A meeting can be conducted through the use of any means of communication by which all participating directors can simultaneously hear each other.\textsuperscript{71} Regular meetings can be held without notice;\textsuperscript{72} special meetings generally require two days' notice;\textsuperscript{73} and meetings can be called by the president, the chairman of the board, or twenty percent of the directors.\textsuperscript{74} Unless the articles, bylaws or special provisions of the Act provide otherwise, a majority of the directors constitutes a quorum,\textsuperscript{75} and the affirmative vote of a majority of the directors present constitutes board action.\textsuperscript{76}

4. \textit{Emergency Bylaws and Powers}

Every organization should make contingency plans concerning corporate functions should a natural disaster or other emergency occur. The new Act has two provisions designed to facilitate action during an "emergency," for example, when a catastrophic event prevents the board from assembling a quorum.\textsuperscript{77} Primarily, the directors may adopt bylaws containing procedures for managing the corporation during an emergency, including how to convene the board, relaxed quorum requirements, and designation of additional or substitute directors.\textsuperscript{78} Secondly, a few special powers are granted to the directors to make it easier to function during an emergency.\textsuperscript{79}

D. Fiduciary Liability of Directors

A director is a type of fiduciary.\textsuperscript{80} His status has a variety of attributes, some of which relate to his representative capacity if

\textsuperscript{70} Id. § 4-33-726.
\textsuperscript{71} Id. § 4-33-820(c).
\textsuperscript{72} Id. § 4-33-822(a).
\textsuperscript{73} Id. § 4-33-822(b).
\textsuperscript{74} Id. § 4-33-822(d).
\textsuperscript{75} Id. § 4-33-824(a).
\textsuperscript{76} Id. § 4-33-824.
\textsuperscript{77} Id. § 4-33-207(d).
\textsuperscript{78} Id. § 4-33-207(a)(1)-(3).
\textsuperscript{79} Id. § 4-33-303.
\textsuperscript{80} See Oleck, \textit{supra} note 5, at § 265; see also Hall v. Staha, 303 Ark. 673, 800 S.W.2d 396 (1990) (discussing Arkansas theories in a business corporation context), reh'g denied, 314 Ark. 71, 858 S.W.2d 672 (1993).
elected by members, some of which are similar to the characteristics of an agent, and some of which are like those of a trustee of an express trust of property. Yet, the relationship which a director has to corporate property is not considered as strict as that of a trustee. Thus, despite the similarities, there are significant differences in the standards of responsibility which are applicable to directors and trustees. Under present law, it is not clear whether nonprofit directors should be treated as corporate directors or as trustees. By adopting the less stringent corporate standard, the 1993 Act not only provides a clear answer to this question, but also addresses the fear of personal liability and encourages people to serve on nonprofit boards. The greater protection afforded to directors strongly favors election under the new Act.

1. Liability of Directors Versus Liability of Trustees

Generally, the points of comparison between director liability and liability of trustees are in three areas: responsibility for management and investment, personal liability for contractual obligations, and vicarious liability for torts of agents. At common law, trustees are held to a higher standard of care in the exercise of their management and investment responsibilities. Trustees also may be personally liable for contractual obligations of the entity unless the contract expressly provides otherwise. In the case of private trusts at least, trustees may have personal liability for the tortious conduct of agents and employees, while corporate directors normally do not have such personal liability.

a. Management and Investment

Corporate directors, as well as trustees, can be liable for losses caused by their negligent mismanagement. However, while trustees are often held to a higher standard of care and may be liable for simple negligence, directors normally are not liable for mere mistakes in judgment, but must have committed gross negligence, intentional misconduct, or some other egregious act.

Despite that difference under common law, the Uniform Management of Institutional Funds Act creates a common standard

81. OLECK, supra note 5, at § 265.
82. OLECK, supra note 5, at § 265.
for trustees and directors in the exercise of their investment responsibilities on behalf of the organizations subject to that act. For the governing boards of charitable, religious, and educational institutions, whether incorporated or not, this law establishes a standard of conduct for the management of funds held exclusively for the institution's own charitable purposes. That standard is expressed as follows:

In the administration of the powers to appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investment, price level trends, and general economic conditions.

b. Contracts

A corporate director usually is not personally liable for the contractual obligations of the corporation. Under general common law rules, however, trustees are personally liable for a contract executed by the trustees, unless such liability is expressly excluded by the terms of the contract. This rule of personal contract liability applies to trustees of charitable trusts as well as to the trustees of private trusts.

c. Torts

Although traditional common law rules impose personal liability upon the trustees of a private trust for the torts of its agents, that

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85. It does not apply to the management of funds in charitable remainder trusts or charitable lead trusts, however, because those "split-interest" trusts have private as well as charitable interests. Id. § 28-69-602(2).

86. Id. § 28-69-607. Section 1809 of the 1993 Act repeals all laws and parts of laws in conflict with the new Act. 1993 Ark. Acts 1147 (codified at Ark. Code Ann. § 4-33-1705 (Michie Supp. 1993)). Thus, if in a given case there is a conflict between the standards of conduct prescribed in these two laws, the standards in the 1993 Act should prevail. Because both laws use an ordinary prudent person standard, however, there does not seem to be a significant difference regarding the standard of care for investment decisions.


88. Restatement (Second) of Trusts § 403; Bogert, supra note 87, at § 401.

89. Restatement (Second) of Trusts § 264; Bogert, supra note 87, at §§ 731-735.
rule does not apply for charitable trusts. In states like Arkansas, where the doctrine of charitable immunity still applies, the doctrine protects both trustees and charitable corporation directors from personal liability for the torts of agents. However, how are nonprofit corporations treated when they do not qualify as charitable? If the private trustee standard were applied, vicarious liability would exist. The standard for corporate directors, on the other hand, generally does not hold them personally liable for the negligence of the corporation's agents and employees, absent unusual circumstances.

Concerned with directors' potential exposure to vicarious liability, the 1987 Legislature enacted a measure designed to protect the directors of tax exempt nonprofit corporations; this measure granted those directors immunity from personal liability for the negligence of employees and other directors. The immunity rule applies not just to directors of charitable corporations exempt under Internal Revenue Code § 501(c)(3), but to those of any nonprofit corporation "that holds a valid federal income tax exemption issued by the Internal Revenue Service." Yet, it is not uncommon in practice to encounter nonprofit corporations of the mutual benefit type which have not applied to the Internal Revenue Service for recognition of exemption. Some organizations, trade associations for example, are entitled to be recognized as exempt without the issuance of an exemption letter by the Service. Directors of those corporations may find under the new Act an additional degree of protection from vicarious liability as long as they meet the standards of conduct prescribed therein.

2. What Standard of Conduct Applies to Nonprofit Corporation Directors?

Historically, some cases have measured the conduct of nonprofit corporation directors by the standards applicable to corporate directors generally, while other courts have held them to the more strict

91. BOGERT, supra note 69, at § 402. Cf., LeMay v. Trinity Lutheran Church, 248 Ark. 119, 450 S.W.2d 297 (1970) (reasoning that the doctrine was grounds for dismissal of suit for damages from fallen tree against Chairman of the Board as well as Church).
92. 1987 Ark. Acts 970 (codified at ARK. CODE ANN. §§ 16-120-101 to -104 (Michie Supp. 1993)). The grant of immunity, however, does not extend to a director's personal negligence. Id. § 16-120-103(a).
standards applicable to trustees. Advocates of the latter view recite the attributes of a director's function, especially in a charitable corporation, which are comparable to those of trustees of charitable trust property. The modern judicial trend, however, is to apply the corporate, rather than the trust, standard of care to the directors of nonprofit corporations. One rationale for this view has been expressed as follows:

The trustee standard is excessively demanding for most directors of nonprofit organizations. Trustees are subject to the highest standards of care and fiduciary conduct. Directors of nonprofit organizations often have other full-time positions and perform their duties as an avocational community service. The "prudent director" test is more realistic and more flexible than the trustee standards.

Additionally, corporate directors may have many areas of responsibility, while a trustee seldom must supervise substantial operations. A trustee's responsibilities more typically are restricted to management of trust funds and disbursement in accordance with the terms of the trust. Accordingly, trustees can be expected to devote more time and expertise to the management of trust funds and investments. In contrast, the directors of large charitable corporations, like hospitals and universities, must supervise the operation of a wide variety of facilities and activities. Since that functioning more closely resembles the corporate model, the less stringent corporate standard of care is more appropriate. This is the approach taken by the RMNCA and the Arkansas Nonprofit Corporation Act of 1993.

3. Standards of Conduct Under the Act

The standards of conduct for directors are established in four sections of the new Act dealing respectively with general standards, conflicts of interest, prohibition of loans to directors, and liability

94. See J. Thomas Eubank, Jr., et al., Duties of Charitable Trust Trustees and Charitable Corporation Directors, 2 REAL PROP., PROB. AND TR. T. 545 (1967).
95. See Kenneth L. Karst, The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility, 73 HARV. L. REV. 433 (1960); see also OLECK, supra note 5, at § 265.
for unlawful distributions. Because the 1993 Act adopts the ABCA rule concerning general standards of director conduct, the development of that rule for business corporations is important to understanding the new measure for nonprofit directors.

Under the common law, the fiduciary duties owed by a director to a business corporation consist primarily of the duty of care and the duty of loyalty. The duty of care or diligence requires a director to act with the care of an ordinary prudent person in a like position under similar circumstances. That familiar expression of the duty of care is codified among the general standards of conduct set forth in the ABCA. This corporate standard of care acknowledges that directors are not guarantors of the success of investments or operations. They can balance risks and rewards, and they are allowed discretion in exercising the judgment necessary to meet the goals of the organization.

The common law duty of loyalty requires directors to act in good faith and in a manner they reasonably believe to be in the best interests of the corporation. That aspect of the duty of loyalty also is included in the general standard under the ABCA. The duty of loyalty also requires directors to refrain from engaging in their own personal activities in such a manner as to injure or take advantage of the corporation. Directors may not derive secret or private profits from official positions, and must give the corporation the benefit of any advantages obtained as a result of an official position. The ABCA has a rule specifically dealing with director conflict of interest transactions.

Directors also owe a duty of obedience which requires adherence to the purposes stated in the charter of the corporation. This duty is equally important in a nonprofit corporation to justify the reliance of donors on the faithfulness of the corporation to the charitable purposes which they intend to support.

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Corporations

a. General Standards

In the context of these principles of business corporation law, the new Act prescribes the general standards of conduct for directors in language which is almost identical to Section 830 of the ABCA. The new Act provides that a director shall discharge his or her duties, including those as a committee member, in good faith, with the care an ordinary prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes to be in the best interests of the corporation. In meeting that standard, a director is entitled to rely on information from staff, committees of the board, and the corporation's attorneys and accountants, in circumstances under which the director reasonably believes the information is reliable. A director is not acting in good faith, however, if he possesses knowledge that makes reliance on such information unwarranted. A director acting in compliance with that standard is not liable to the corporation, to any member, or to any other person. This exoneration of directors from liability is automatic, and it protects them from the claims of third parties. As is the case under the existing immunity statute, however, a director is not exonerated from his own tortious conduct.

Section 830 of the new Act contains the additional statement that a director shall not be deemed to be a trustee with respect to property of the corporation, including any that may be subject to restrictions imposed by a donor. This rule insulates directors from personal liability for claims of breach of trust by donors unhappy with the way donated assets have been used. It is important, however, to distinguish the responsibility of the directors from the responsibility of the corporation. The corporation can be considered a trust even if the directors are not held to the same standard of conduct as trustees. While trustees, and not directors, hold legal title to trust property, the corporation is the holder of legal title to its assets. In that capacity, the corporation is impressed with a trust that its property be used consistently with the expressed charitable purposes and with any additional restrictions imposed by donors as conditions of their gifts. Thus, the law may permit a charitable corporation to be sued for breach of trust even though the directors are exonerated.

104. Id.
by statute from such claims. This corporate trust concept led the drafters of the RMNCA to exclude claims which allege that the corporation lacks power to dispose of assets held in charitable trust from the general rule prohibiting challenges on ultra vires grounds.

It seemed to our Committee also that this approach strikes an acceptable balance between the interests of encouraging community service, by limiting potential director liability, and encouraging the support of charity by preserving donors' reliance upon a corporation's faithfulness to use gifts for their intended purposes.

These basic rules of Section 830 are designed as the exclusive standards by which to measure directors' conduct. Just as the statutory models from which they are derived, the rules are subject to further development by judicial interpretation and application. This statute and the context of its origins will provide the blueprint for those decisions.

b. Business Judgment Rule

Uncertainty exists as to whether and under what circumstances the business judgment rule may be applied to nonprofit corporations. On the premise that directors of business corporations are better equipped to make business judgments, courts will sometimes defer to their judgment and will apply the rule to create a rebuttable presumption that the directors acted in good faith, with reasonable diligence, and without self-dealing or personal interest. Section 830 of the ABCA does not attempt to codify the business judgment rule or to delineate any conflict which may exist between the statutory standard and the rule. The new Act follows that approach for nonprofits as well. If a nonprofit director meets the standards of Section 830, no issue exists concerning the application of the business judgment rule. Where compliance with the statutory measure cannot be established, however, then a court may consider the application of the rule. It may seem odd to consider the business judgment rule for corporations which do not engage in business for profit. Yet, the fundamental theory of the rule sensibly applies for determining the financial decisions and other important determinations which

108. Id.
110. Hall, 303 Ark. at 678, 800 S.W.2d at 399.
112. REVISED MODEL NONPROFIT CORP. ACT, § 830, cmt. 3 (1988).
nonprofit boards must make; indeed, some courts have applied the rule to nonprofits.\textsuperscript{113}

c. Exculpation Provision Not Adopted

The RMNCA contains an alternate section 8.30(d), which allows the corporation, by including a provision in the articles of incorporation, to limit or eliminate directors' liability for damages for breach of the duty of care. Like its business corporation counterpart, the optional director-exculpation clause is severely limited; the clause does not permit the articles to limit director liability for breach of the duty of loyalty, for actions not in good faith, for intentional misconduct, or where a director derives an improper personal economic benefit. This alternate provision was derived from Section 102(b)(7) of the Delaware General Corporation Law, which was enacted following an adverse decision of the Delaware Supreme Court.\textsuperscript{114} The specific problem that was the impetus for the legislation concerned a dispute over the adequacy of the price at which a merger was approved. The policy goals of that measure are understandable, and the Committee was aware that our legislature had enacted the ABCA with an exculpation clause.\textsuperscript{115} In the nonprofit context, however, the Committee believed that it would be bad policy to permit the exculpation of directors from fulfilling the basic corporate duty of care. For that reason, the Committee decided not to include an exculpation clause in the legislative proposal.

d. Conflicts of Interest

The conflict of interest section of the new Act establishes an additional standard of director conduct which provides a clear pathway for the corporation to approve or to ratify director conflict of interest transactions.\textsuperscript{116} A conflict of interest transaction occurs when a corporation enters a transaction in which a director has a direct or indirect interest. A director has an indirect interest in a transaction if the director has a material interest or is a general partner, officer, director, or trustee of the entity which is a party to the transaction. A conflict of interest transaction is not voidable if the transaction


\textsuperscript{114} See Rosenzweig, supra note 92, at 339-40; REVISED MODEL NONPROFIT CORP. ACT alternative section 8.30, cmt. (1988).

\textsuperscript{115} ARK. CODE ANN. § 4-27-202 (Michie 1987).

\textsuperscript{116} Id. § 4-33-831 (Michie Supp. 1993).
was fair to the corporation at the time it was entered into; disclosure of the material facts of the transaction, and the director’s interest, was made or known to the board of directors, and the board authorized, approved, or ratified the transaction; or, the material facts of the transaction and the director’s interest were disclosed or known to the members and the members authorized, approved, or ratified the transaction.

This standard of the new Arkansas Act differs slightly from the model act. In both acts, a demonstration of actual fairness suffices without meeting any approval test. But under Section 8.31 of the RMNCA, the circumstances in which a conflict of interest transaction may be validated by approval are somewhat more restricted for public benefit and religious corporations than for mutual benefit corporations. For the latter, advance approval or later ratification by the members or directors after full disclosure suffices; for the former, advance approval by the directors after full disclosure is required, and there is an additional requirement that the directors approving the transaction must in good faith reasonably believe it to be fair to the corporation. While appreciating the policy behind the provision, the Committee believed that having those different standards would unnecessarily add to the complexity of dealing with the new law. The common requirement for all corporations under the Arkansas Act, that either the actual fairness test or the full disclosure test must be met, is an adequate safeguard for dealing with conflict of interest transactions.

A conflict of interest transaction is approved if it receives the affirmative vote of a majority of the directors on the board who have no direct or indirect interest in the transaction. However, a transaction may not be approved by a single director. If a majority of the directors on the board who have no interest in the transaction vote to approve the transaction, a quorum is present for this purpose. The articles, bylaws, or resolutions of the board may impose additional requirements on conflict of interest transactions.

e. Loans and Distributions

A nonprofit corporation may not lend money to or guarantee the obligation of a director or officer of the corporation. However, a violation of that rule does not affect the borrower’s liability on the loan. Under the new Act, a director who votes for or assents to an unlawful distribution is liable to the corporation unless the

117. Id. § 4-33-832.
director complies with the standards of conduct described above.  

E. Indemnification of Directors and Officers

The practice of indemnifying nonprofit directors was not unheard of previously, but no statutory authority existed for it. By providing for indemnification in several ways, the 1993 Act contains additional protection for directors. To the extent that a director is wholly successful (on the merits or otherwise) in the defense of a proceeding, the statute requires the corporation to indemnify against legal expenses, unless the articles of incorporation provide otherwise. Even if the director is unsuccessful in his defense, however, the corporation is permitted to indemnify against judgments, settlements, and expenses, including attorneys' fees, if the director acted in good faith and in a manner he reasonably believed to be in the best interests of the corporation. An adverse ruling in the proceeding is not determinative that the director failed to meet those standards. Where a corporation has failed to pay a director who is otherwise entitled to indemnification under either provision, the director may apply to the court conducting the proceeding or to another court of competent jurisdiction for an order compelling payment by the corporation. Similar rules apply to indemnification of officers. Another section expressly authorizes a nonprofit corporation to maintain directors' and officers' liability insurance, whether or not it has the power to indemnify under either the mandatory or permitted indemnity rules.

Authority for indemnification pursuant to the new Act may be expressed in the articles, bylaws, resolutions of members or directors, or in a written contract or otherwise, but any such expression of authority must be consistent with the indemnification provisions of the Act. Before any permitted indemnity may be offered, the corporation must make a determination in that specific case that the prerequisite standards of conduct have been met. That determination may be made in any of four different ways. If a quorum can be obtained from among the directors who are not involved in the proceeding, a majority of that quorum can make the determination. The board can appoint a committee of directors

118. Id. § 4-33-833.
119. Id. § 4-33-852.
120. Id. § 4-33-851.
121. Id. § 4-33-854.
122. Id. § 4-33-856.
123. Id. § 4-33-857.
124. Id. § 4-33-858.
125. Id. § 4-33-855.
who are not parties to the proceeding to decide the issue. Special legal counsel can be appointed to make the determination, especially where all of the directors are parties. In the case of a mutual benefit corporation, the decision can be made by the members.

F. Officers

The Act requires a nonprofit corporation to have at least a president, a secretary, and a treasurer, unless the articles or bylaws provide otherwise. However, the same person may simultaneously hold more than one office. Apparently without allowing any exception, the old act could be construed to require the service of at least four persons as officers: those three named above, plus a vice-president. The standards of conduct for officers with discretionary authority are similar to those applicable to directors. The directors may remove any officer at any time with or without cause, but just as the appointment of an officer does not create contract rights, removal does not affect the officer’s contract rights. If a contract or other instrument is signed by the chairman and president, or by one of them plus a vice-president, secretary, treasurer, or executive director, the corporation is bound by the document unless the other party knew the officers signed it without authority.

III. FACTORS FAVORING THE ELECTION

The preceding description of a few key features of the new Act highlights some of its most important benefits for old corporations considering election under the new Act. In the broadest sense, the provision of a comprehensive set of laws for the management of a nonprofit corporation is perhaps the greatest advantage of the Act. The ultra vires statute, the clear and complete rules for conducting meetings of members and directors, and the authorization for taking action without a meeting, all facilitate the approval of corporate transactions in a manner which is less likely to be challenged. The elimination of procedural questions regarding amendments to the

126. Id. § 4-33-840(c). Because the number of directors must be no less than three, however, there can be no one-man nonprofit corporations. Id. § 4-33-803.
128. Id. § 4-33-842 (Michie Supp. 1993).
129. Id. § 4-33-843(b).
130. Id. § 4-33-844.
131. Id. § 4-33-845.
articles, voluntary dissolution, and the sale of substantially all assets, makes it easier to accomplish those transactions in a valid manner. Even though they may apply only rarely, the provisions for acting in an emergency are an enhancement as well.

In addition, the conflict of interest rules, which allow a clear way to approve transactions with directors' firms, can be important to many nonprofit organizations. Because the governing boards of such corporations are often broadly representative of the businesses in a community, a nonprofit board often includes persons affiliated with banks which have loans with the corporation, securities firms which hold investments for it, contractors who construct facilities for it, and other vendors who supply various products or services to the organization. Those relationships can be important to the success of a nonprofit organization. Thus, a distinct advantage of the new law is that it provides a fair method for approving transactions with companies represented on the board in a manner which is certain to be valid and which is without risk of personal liability to the directors.

In many cases, one of the strongest incentives to elect under the new law will be to take advantage of the statutory provisions for indemnification of directors. Even though few reported Arkansas decisions exist which involve claims of personal liability on the part of corporate directors, litigation against nonprofits and their directors is increasing nationally. Some of the types of claims asserted include employment discrimination, sexual harassment, claims under the Americans with Disabilities Act, breach of contract, fraud and conversion, negligent hiring, damages for injuries sustained at sponsored events, environmental liabilities, antitrust violations, and securities law violations. The clear authority to indemnify directors and to provide directors' and officers' insurance will be increasingly important if nonprofit corporations are to continue to attract capable people for service without compensation on their boards. No Arkansas cases concern this issue, but other states' courts have ruled that there is no right to indemnification in the absence of express statutory authority. The provisions in the new Act for mandatory indemnification where the prerequisites are met, for voluntary indemnification by the corporation, and for the purchase of directors' and

132. See, e.g., Borgeest, supra note 102, at 7; Harvey, supra note 107, at 669-733.
officers' insurance will eliminate any questions about authority to insure and to indemnify for corporations which elect to be governed by the new law.

Similarly, clarifying the standards of conduct for directors as the more lenient corporate measure will encourage community service and will offer another primary reason for nonprofits to consider the election. Although in our state the doctrine of charitable immunity continues to protect directors from vicarious liability for the torts of employees, there can be questions about whether a particular corporation qualifies as a charity. While our immunity statute affords additional protection to the directors of all tax exempt corporations, some nonprofits do not have an exemption letter from the Internal Revenue Service. Furthermore, suits against directors involving many of the other types of claims mentioned above may not fall under the immunity umbrella. The exoneration from third party claims of directors who comply with the exclusive standards of conduct under the new Act will provide a convincing reason for many corporations to make the election.

IV. Procedure for Making the Election

A nonprofit corporation, incorporated under the old statutes, may elect to be governed by the provisions of the new Act by amending its articles of incorporation to so provide. The amended articles, of course, must declare the correct classification pursuant to the fixed rules for existing corporations, and must otherwise comply with the new law. The amendment does not have to be approved by the circuit court. This election may be made at any time after December 31, 1993. Once the election is made, it is irrevocable. The amendment effecting the election must be approved by a two-thirds vote of the members, or if there are no members, by a two-thirds vote of the directors. Existing corporations which do not elect to be governed by the new Act will continue to be governed by the old law.

V. Conclusion

The foregoing discussion obviously is summary in nature, and it would be impossible here to identify every facet of Arkansas law

136. The old statute on amendments only requires filing with the Secretary of State (Ark. Code Ann. § 4-28-206(d) (Michie 1987)), and the Office of the Secretary of State advises that it will not require a circuit court order approving the amendment. Telephone interview with Jim Werner, Secretary of State Staff Attorney (December 16, 1993).
which will be significant to those pre-1994 corporations considering
the new Act election. Each corporation should independently research
the issue with the assistance of counsel. Especially because it is
irrevocable, the election should be made only after careful delib-
erations among the staff, directors, and members. Their study of
the new law should include a review of the rules and procedures
that would become applicable to their type of corporation, and a
determination that the organization can effectively function under
those rules. For example, compliance with the detailed administrative
rules for conducting meetings and votes may be a burden for some
entities which have members. There also may be problems posed
by the new Act that are specific to particular organizations. Yet,
the key advantages, gaining a comprehensive set of corporate laws,
facilitating valid corporate action, authorizing indemnification, and
establishing clear standards of conduct, which provide directors with
greater protection in an increasingly litigious society, will influence
many corporations to make the election to be governed by the new
Act.