

# **Legal and Ethical Solutions for All Associations**

## **The Top Eight Legal and Liability Issues That Impact Regional Association Boards the Most**

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The size of your association doesn't really matter when it comes to legal, liability and ethical issues. Large or small, we all have to be aware of and careful about what we do, what we say, how we do things and where we're most vulnerable without being paranoid, too conservative, or overly cautious. There are enough legal and ethical pitfalls to fill a black hole, but it's important that volunteer leaders and our associations' staff understand and agree on the most reasonable business practices to avoid legal entanglements and to fulfill their fiduciary responsibilities.

The following summary, focusing on the top legal responsibilities any non-profit board should know about, is borrowed in part from resources published by the American Society of Association Executives. It provides an opportunity for an interactive discussion on some of the more commonly encountered questions, issues and problems that associations are often engaged in managing. The list is not exhaustive, but the topics point out how complex and sometimes confusing association management can be, for both volunteers and management staff.

### **1. Incorporation and Tax-exemption**

It is important that directors understand that, irrespective of where the association's offices are, the corporate law applicable to their conduct as directors is the law of the state where the association is incorporated.

Associations managed by association management companies often are incorporated in states other than the state where the AMC's office is located. Although most state non-profit corporation statutes are similar, there are differences from state to state that may impact the extent of a director's fiduciary duty to the association; the AMC must take responsibility for educating directors regarding their obligations under applicable state law.(1)

Why incorporate at all? Incorporation of non-profit organizations provides the same types of insulation from personal liability of directors and members that are common with for-profit entities. Incorporation protects association members from personal liability because the corporate entity stands as a barrier between the association's members and any person or company to whom the association is legally obligated.

Forming a non-profit organization, incorporated or not, does not automatically bestow tax-exempt status. Attaining tax-exemption for federal income tax involves an application process during which the organization must describe the purpose and mission of the organization. That purpose, by which the organization will be measured, becomes very important whenever the organization provides services and programs to its members. Revenues from programs, or services that are deemed to be “un-related” to the exempt purpose declared in the application to the IRS may then be taxed, under the IRS’ Unrelated Business Income Tax guidelines.

The most common forms of tax-exempt status for associations are described under the IRS code as 501(C)(3), or 501(C)(6). The first is typically provided to organizations that meet certain *educational, philanthropic, scientific, or religious* purposes and the memberships of those organizations usually take the form of individual memberships. They are often referred to as *professional societies*.

The latter status is reserved for associations that are “business leagues,” or trade groups, like most of the associations in the promotional products industry. Company, rather than individual, memberships are the most common form for trade associations.

501(C)(3) organizations are eligible for non-profit postal rates, where usually 501(C)(6) groups are not. Trade groups have more latitude in lobbying than professional societies and both types provide for exemption from federal income tax on revenues that flow from programs that meet the exempt purpose test.

Tax-exempt associations can risk their exempt status by

- focusing on providing services to members rather than on promoting the industry in general,
- providing benefits to individual members that are not available to others,
- engaging primarily in for-profit activities, or
- over-compensating staff.

An association’s tax-exempt status impacts everything from its dues statements to its internal accounting procedures to its membership promotional materials to the structure of a tradeshow and annual meeting.(1)

## **2. Duty of Care**

Every state imposes upon corporate directors, by statute and by court-created legal precedents, fiduciary duties to the association. Fiduciary comes from a Latin word meaning *trust*. Because your associations’ assets are held in trust for the accomplishment of its mission, the assets do not belong to your board, your staff, or even the members. However, the ultimate authority for managing your association’s affairs is vested in your board. Because the law grants you such authority, the law also imposes on you a standard of performance—an obligation to act in the organization’s best interests.(3)

The board’s first obligation is a duty of care with respect to association matters.

This duty (the level of competence expected of a board member) is often defined as the care that an ordinarily prudent person would exercise in a like position under similar circumstances. No longer are non-profit directors subject to a lesser competence standard than are directors of for-profit corporations.

Prospective association directors need to be told, in advance of agreeing to serve on the board, that such service carries with it an obligation to take association matters seriously and to devote time to consideration of issues facing the association.

Directors may not rubberstamp the proposals of the association's officers, or staff without running the risk of breaching their fiduciary duty of care to the organization. It also imposes on members an obligation to protect any confidential association information.(1)

### **3. Duty of Loyalty**

The second fiduciary duty imposed on directors is one of loyalty to the association. Directors are required to make decisions based on what is best for the association, not what may be advantageous to their company or even to their constituency within the association—in other words, retailers as opposed to manufacturers, or distributors.

Once the board of directors makes a decision, each director, even those who may have opposed the course of action chosen by the board, must act consistently with that decision. Disagreement is permitted, but director actions inconsistent with the board decision are not.

This duty prohibits competition by an association director, or officer with the association itself. Directors are prohibited from appropriating for themselves, or their companies opportunities that could be taken advantage of by the association. Directors seeing such a business opportunity (perhaps an internet presence that could serve as a source of non-dues revenue for the association) must first bring that opportunity to the association board for consideration; only after the board has considered and rejected such an opportunity may the director take advantage of it. In this regard, directors stand in a different relationship to the association than do other members.(1)

Another aspect of this duty is that of "apparent authority." Associations are responsible for the illegal activities of their volunteers if the volunteer "appeared" to be acting with the authority of the association—even when the association's board of directors did not approve the activities, did not benefit from them, or did not even know about them. Associations must limit who is authorized to act, or speak for the association.(2)

### **4. Duty to Avoid Conflicts of Interest**

Association directors should be instructed that they must avoid actual and even perceived conflicts of interest when making decisions at the board level. Directors having a personal, or business interest in a matter under board consideration must disclose that interest to the board. Disclosure is paramount.(1)

The board, applying the standard set forth in the applicable state statute, supplemented perhaps by the association's conflict of interest policy, will then decide to what extent, if

any, the director disclosing the conflict may participate in discussing, or voting on the matter.(1)

A conflict of interest may exist when a board member participates in the deliberation and resolution of an issue while he or she simultaneously holds professional, business, or volunteer responsibilities outside the association that could predispose, or bias him or her one way, or another regarding the issue. The board has the ultimate say in determining whether a director, or officer has a conflict and in determining how to avoid, or mitigate that conflict.(2)

## **5. Duty to Preserve Confidential Information**

Directors must not disclose to others information that a board has determined to be confidential, such as communication between the association board, or senior staff and legal counsel, information specific to individual member companies and minutes of executive sessions of the board.(1)

Associations should consider having its board directors and staff sign non-disclosure agreements that point out the importance of maintaining confidentiality. Breaching confidentiality can cause serious harm to the organization, or to other parties who are depending on non-disclosure.

## **6. Avoiding Legal Liability**

Because association directors are volunteers, they quite properly have no interest in exposing their personal, or company assets as a consequence of their activities on behalf of the association.

As part of their orientation, directors should be assured that they will have no personal liability in connection with their board service, provided they act in good faith. Even if they exercise poor judgment, directors are not at risk as long as they do not act recklessly.

The federal Volunteer Protection Act of 1997 limits the personal liability of non-profit directors, provided they are

- not compensated for their board service,
- acting within the scope of their board responsibilities, and
- not engaging in criminal, or reckless misconduct.

Many states have enacted similar legislation protecting association volunteers. Further, most association bylaws contain provisions indemnifying and agreeing to defend current and former officers, directors and other volunteers in the event a claim is made against them arising out of their service to the association.

Directors, particularly those serving smaller, less financially stable associations, should be further comforted by the fact that the association's indemnification obligations are usually covered by a policy of association professional liability insurance.(1)

Most Directors and Officers insurance policies ordinarily treat as “insured parties” not only the association entity itself, but also all volunteers and staff. Most policies will pay the legal defense costs and any resulting settlements, or damages from claims of wrongdoing by the insured association, or its leadership, including in the areas in which claims against associations are most frequent—employment and human resources and most serious—antitrust and trade regulation.(2)

## **7. Understanding Association Governance**

An orientation program for new directors also should contain an explanation of the various sources of rules that determine how an association is governed. Of course, the non-profit corporation statute of the association’s state of incorporation is the first source of guidance for governance questions.

Association directors need to become familiar at least with the fact that the applicable statute supersedes any inconsistent provisions in the association’s internal governing documents.

The association’s articles of incorporation, bylaws, board-adopted policies and procedures and usually, the most recent edition of the parliamentary procedure authority referenced in the bylaws, are the internal sources of the rules that will govern the operation of the association.(1)

The directors have the obligation to attend board meetings and participate on conference calls. Directors are held accountable for the actions taken at board meetings that they did not even attend.

Directors must also take steps to ensure they are informed by reading and understanding reports and materials prepared for the board, that appropriate records are kept of meetings and decisions, that financial systems and controls are in place and that independent evaluations, audits and appraisals are obtained whenever necessary.

## **8. Antitrust Laws**

All directors should receive annual training concerning antitrust laws. This training should be but a part of the association’s formal antitrust compliance program. Directors must understand that

- the antitrust laws prohibit agreements that unreasonably restrain competition,
- certain anticompetitive conduct is presumed to be unreasonable,
- agreements in violation of the antitrust laws can be inferred from similar conduct,
- the association can be implicated in unlawful conduct even if the agreement is not reached during an association meeting, and
- the board must heed the advice of legal counsel, or the association’s staff to discontinue a particular discussion, or not to engage in certain conduct.(1)

Associations are voluntary organizations of members, many of whom compete with one another. Therefore, virtually any action that an association takes and particularly actions that involve the attempted private regulation of an industry, profession, or business, may raise antitrust issues.

Violations fall into two basic categories: actions that are unlawful without regard to their actual impact on competition (called *per se* violations) and actions that are not necessarily unlawful, but may be so depending on their actual impact on competitive conditions (called *rule of reason* violations). Actions that are likely *per se* unlawful include the following: (a) agreements fixing prices, or fees, or setting floors, or ceiling on prices, or fees; (b) agreements to boycott competitors, suppliers, third party payers, or customers/patients/clients; (c) agreements among competitors dividing, or allocating markets; (d) agreements coerced by a provider with a dominant market position tying the purchase, or provision of one product, or service to the purchase, or provision of another product, or service. Any other agreement, including resolutions of an association of competitors, may violate the antitrust laws under a “rule of reason” analysis if its effect is generally to raise prices, or fees, or to reduce the quality, or quantity of available goods, or services.

Antitrust laws can be violated by mutual understandings, or other informal arrangements falling far short of a formal contract, or written resolution. Directors and officers of associations, or just ordinary members can implicate their associations in antitrust violations by using the associations to facilitate their undertaking anticompetitive arrangements, even without invoking any of the formal mechanisms of the association. Under the “apparent authority” doctrine, an association may be held responsible for anticompetitive conduct by volunteers who appear to be acting in the name of the association.(2)

#### Sources:

- (1) “Legal Orientation of New Board Members,” C. Michael Deese, *Association Management*, published by ASAE, January 2003.
- (2) “Your Legal Responsibilities,” Jerald A. Jacobs, *Associations Now/The Volunteer Leadership Issue*, published by ASAE & the Center for Association Leadership, January 2006.
- (3) “Your Legal Duties,” Paula Cozzi Goedert, *Association Management*, published by ASAE, January 2004.