Last Updated: January 2010

COLORADO GOVERNANCE PRINCIPLES

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Following revelations concerning the Enron and WorldCom scandals in 2001-02, the issue of corporate governance rose to the top of the national agenda in the United States. To curb the practices that led to these and similar scandals by publicly held corporations, Congress enacted the Sarbanes-Oxley Act of 2002. Moreover, since social sector organizations also had their share of scandals involving conflicts of interest, self-dealing by insiders, excessive compensation and similar topics, several states have proposed laws to extend Sarbanes-Oxley-type provisions to nonprofit entities, with California being the first to enact such legislation and several states following shortly after.

Given this legal landscape, organizations devoted to positive social change strive to institute and maintain good governance practices, including transparent decision making, accurate financial reporting, and accepted auditing practices. In the discussion below, we outline several of the good governance principles embodied in the Sarbanes-Oxley Act and in Colorado state law applicable to social sector organizations.

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1. The Sarbanes-Oxley Good Governance Principles

Except for provisions concerning document destruction and whistleblower protection, the governance provisions required by the Sarbanes-Oxley Act apply only to public companies and not to social sector organizations. Nevertheless, the reforms prescribed by the Sarbanes-Oxley Act have become a touchstone for the governance principles and practices of many entities. Consequently, most social sector organizations, both for-profit and nonprofit, are voluntarily incorporating Sarbanes-Oxley principles into their own governance structures as a way of instilling confidence and trust among their members, donors, grantors, and other constituents.

In 2005, the ABA Coordinating Committee on Nonprofit Governance published a "Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley" in which they provided 10 general principles that they described as potentially being "worthy of consideration for the governance of nonprofit organizations." Those principles, which may or may not be appropriate for a particular organization, are:

a. **Role of Board:** The organization's governing board should oversee the operations of the organization in such manner as will promotes effective and ethical management.

b. **Importance of Independent Directors:** The independent and non-management board members are an organizational resource that should seek to assure the exercise of independent judgment in key committees and general board decision-making.

c. **Audit Committee:** An organization with significant financial resources should have an audit committee composed solely of independent directors that seeks to assure the independence of the organization's financial auditors, reviews the organization's critical accounting policies and decisions and the adequacy of its internal control systems, and oversees the accuracy of its financial statements and reports.

d. **Governance and Nominating Committee:** An organization should have one or more committees, composed solely of independent directors, that focus on core governance and board composition issues, including the governing documents of the organization and the board; the criteria, evaluation, and nomination of directors; the appropriateness of board size, leadership, composition, and committee structure; and codes of ethical conduct.

e. **Compensation Committee:** An organization should have a committee composed of independent directors that determines the compensation of the chief executive officer and determines or reviews the compensation of other executive officers, and seeks to assure that compensation decisions are tied to the executives' actual performance in meeting predetermined goals and objectives.

f. **Disclosure and Integrity of Institutional Information:** Disclosures made by an organization regarding its assets, activities, liabilities, and results of operations should be accurate and complete, and include all material information. Financial and other information should fairly reflect the condition of the organization, and be presented in a manner that promotes understanding. CEOs and CFOs should be able to certify the accuracy of financial and other disclosures, and the adequacy of their organizations' internal controls.

g. **Ethics and Business Conduct Codes:** An organization should adopt and implement ethics and business conduct codes applicable to directors, senior management, agents, and employees that reflect a commitment to operating in the best interests of the organization and in compliance with applicable law, ethical business standards, and the organization's governing documents.

h. **Executive and Director Compensation:** Executives (and directors if appropriate) should be compensated fairly and in a manner that reflects their contribution to the organization. Such compensation should not include loans, but may include incentives that correspond to success or failure in meeting performance goals.

i. **Monitoring Compliance and Investigating Complaints:** An organization should have procedures for receiving, investigating, and taking appropriate action regarding fraud or noncompliance with law or organization policy, and should protect "whistleblowers" against retaliation.

j. **Document Destruction and Retention:** An organization should have document retention policies that comply with applicable laws and are implemented in a manner that does not result in the destruction of documents that may be relevant to an actual or anticipated legal proceeding or governmental investigation.

Many of these principles now intersect with, and to some extent overlap with, the IRS Form 990 policies and procedures disclosures described below.

2. IRS Encourages Good Governance Policies

The Internal Revenue Service ("IRS") also is encouraging improved nonprofit governance in three ways. First, it is adopting a checklist to help IRS examiners determine whether an organization's governance practices affect its tax compliance. Second, the IRS is training its employees on how nonprofit governance affects determinations and rulings. Third, the IRS is engaging in subtle regulation of nonprofit corporate governance through new requirements in its Form 990.

Form 990, the IRS's annual reporting requirement for nonprofit corporations, mandates a variety of disclosures and makes this information available to the public. Beginning with filings due for 2009, Form 990 has been substantially revised to incorporate a series of "yes" or "no" questions relating to the nonprofit corporation's governance principles and practices. Although the Form does not mandate specific "correct" answers, these disclosures are of great importance to a nonprofit corporation because they are often reviewed by donors, rating agencies, local tax regulators, as well as by members of the corporations themselves. The IRS may also use responses to evaluate which tax returns warrant more careful review or possible audits. Therefore, revised Form 990 provides a substantial incentive for nonprofits to adopt many of these principles and practices not otherwise required by law. More information and resources regarding the IRS and good governance are available at: www.irs.gov/pub/irs-tege/governance_practices.pdf.

a. Independent Directors

Form 990 asks about the independence of the directors of a nonprofit corporation by requiring the nonprofit corporation to disclose the number of "independent" directors, as defined in the Form 990 instructions. Under the instructions, a director is considered to be "independent" if all three of the following circumstances applied at all times during the nonprofit corporation's tax year:

- The director was not compensated as an officer or other employee of the organization or of a related organization (with a limited exception for certain members of religious organizations);
- The director received total compensation as an independent contractor from the organization or other related entity of less than $10,000 for the year; and
- Neither the director nor any family member was involved in a transaction, either with the organization or with a related organization, which was required to be reported under Schedule L of the Form 990.

This Form 990 disclosure focuses on compensation received by the director or a relative from the organization or a related entity. A comparison of the number of "independent" directors to the total number of directors could color the view of the IRS and the public as to the overall governance practices of the nonprofit corporation.

Another related question in the Form 990 asks the organization to identify any officer, director, or key employee who has a family relationship or a business relationship with another officer, director, or key employee. The instructions clarify that this question does not pertain to relationships in the ordinary course of business, attorney/client relationships, or certain other professional relationships. If a relevant relationship is

discovered, Form 990 requires at least the disclosure of the names of the parties and a general description of the relationship.

b. Policies and Procedures

Form 990 asks whether nonprofit corporations have adopted a number of different policies and procedures related to corporate governance. As mentioned above, while these policies are not required by law, an implication could be drawn that a well run nonprofit corporation would adopt them. Some of the more significant policies and procedures include:

i) Conflict of Interest Policy

For several years the IRS has strongly encouraged the adoption of a conflict of interest policy for nonprofit organizations under §501(c)(3). Form 990 is most concerned with conflicts of interest arising where an officer, director, or a manager may benefit financially from a decision he or she could make in such a capacity. Nonprofit organizations must disclose whether a written conflict of interest policy exists and how it is implemented. Additionally, nonprofit corporations must disclose whether officers, directors, trustees, and key employees are required to frequently provide updates on interests that could give rise to these types of conflicts, such as a list of family members, substantial business or investment holdings, and transactions or other affiliations with potentially conflicting parties.

ii) Whistleblower Policy

Form 990 asks if nonprofit corporations have effective whistleblower policies in place. Such a policy must specify the process to be used for reporting confidentially on any potential wrongdoing so that the organization can investigate and, if necessary, correct any problems while eliminating the chance of retaliation against the whistleblower.

iii) Record Retention and Destruction Policy

In accordance with the Sarbanes-Oxley Act, Form 990 asks if nonprofit corporations have a written policy in place covering not only document retention and destruction, but also standards for document integrity, such as guidelines for handling electronic files, backup procedures, archiving of documents, and regular checks to determine the reliability of the document maintenance system.

iv) Compensation Policy

This question in Form 990 asks if a nonprofit corporation has a policy in place for determining whether the compensation of its top management officials is reasonable. An affirmative answer to this question requires the compensation

policy to include: a review and approval by a compensation committee within the organization that is free from conflicts of interest, use of data as to comparable compensation for similarly qualified persons in functionally comparable positions, and contemporaneous documentation and recordkeeping with respect to deliberations and decisions regarding the compensation arrangements.

v) Joint Venture Policy

If a nonprofit corporation engages in joint ventures or similar arrangements, such as partnerships, whether with nonprofit or for-profit partners, it must state whether it has in place a written policy governing such matters. A joint venture policy is defined as one that safeguards the organization's tax-exempt status during its participation in the endeavor.

vi) Form 990 and Governance Disclosure Policies

The Form also requires a nonprofit corporation to disclose its methods for making the form and any other governance documents available for public viewing. This includes a narrative description as well as the name and address of the person possessing the books and records of the corporation.

vii) Chapter Relations Policies

The Form asks whether multilevel associations have policies and procedures to ensure mission consistency throughout the organization, including chapters, affiliates, and branches. Many nonprofit corporations engage a lawyer to review a Form 990 before submission, due in part to the increased complexity and legal implications associated with these new disclosures.

3. Governance Under Colorado Law

In the State of Colorado, nonprofit corporate governance is largely governed by the Colorado Revised Nonprofit Corporation Act ("the Act").

a. Fiduciary Duties

Colorado law establishes specific fiduciary duties for nonprofit directors including a duty of care and a duty of loyalty. The Act requires directors and officers to fulfill their duty of care by: 1) acting in good faith, 2) with the care an ordinarily prudent person in a like position would exercise in similar circumstances, and 3) in a manner the director or officer reasonably believes to be in the best interests of the nonprofit organization.

"Good faith" generally requires that a director acts honestly, with faithfulness to their duties and obligations, and does not attempt to take advantage of the organization. "Care of an ordinary prudent person…in similar circumstances" requires that a director act in accordance with their specific role within the organization. Finally, a director must not

only subjectively believe that his or her acts are "in the best interests of the nonprofit organization," but those beliefs must also be *objectively* reasonable.

Examples of specific actions directors should take in order to exercise their duty of care include:

- Fulfilling their responsibilities with diligence, attention, care and skill
- Becoming familiar with the business of the organization in general including its activities, goals, size, complexity and financial status
- Confirming that the nonprofit has completed required filings
- Making informed decisions by conducting a thorough review of all materials submitted to the board of directors
- Attending and actively participating in all board meetings, events, and substantial decisions made within the organization

The duty of loyalty requires directors to act in the best interest of the corporation and avoid conflicts of interest. One aspect of this duty is a prohibition on usurping opportunities of the organization. Thus, directors must not engage in enterprises directly in competition with or having an injurious or detrimental effect on the organization. Directors also must refrain from using confidential information of the organization for purposes outside the scope of their duties. Finally, the Act prohibits directors from making distributions of profits or assets of a nonprofit corporation to insiders or third parties except in limited circumstances.

Colorado law deals with conflicts of interest by regulating conduct relating to conflicting interest financial transactions. A "conflicting interest transaction" involves a contract, transaction or other financial relationship between a nonprofit corporation and a director, a party related to the director, or an entity in which a director is a director or officer or has a financial interest. While conflicting interest transactions are generally to be avoided, the Act provides two options for allowing these types of transactions under certain circumstances. First, a conflicting interest transaction may be allowed if the important facts of the transaction are presented to the board of directors (or voting members), who authorize the transaction in good faith, with common sense and informed judgment, and by an affirmative vote of a majority of the disinterested voters. Second, a conflicting interest transaction may be approved if it is truly "fair" to the nonprofit organization. Fairness is determined by evaluating whether there was full disclosure regarding the details of the transaction, whether the amounts paid or charged were reasonable, and whether transaction is in the best interest of the nonprofit organization.

Notwithstanding the above, Colorado law prohibits the making of a loan by a nonprofit corporation to a director or officer of the corporation and imposes personal liability for

the repayment of any such loan on each director or officer who assents to or participates in the making of the loan.

b. The Board of Directors

Colorado law provides specific requirements for a nonprofit corporation's board of directors by regulating its size, terms, composition, and conduct. Unless otherwise provided in the corporation's articles of incorporation, the Act requires a nonprofit corporation to have a board of directors composed of at least one director, and the number of directors must be stated in the organization's bylaws. Each director must be an "individual," and thus corporate entities may not serve on a board. Unless otherwise provided for in the bylaws, a Colorado nonprofit corporation must have a president, a secretary, and a treasurer, each of whom must be eighteen years of age or older and one person may play multiple roles. Absent a provision in the bylaws fixing the terms of office, a director's term of office is one year. Finally, while some nonprofit organizations discourage paying compensation to board members (except reimbursement of expenses), both federal and Colorado law mandate that any compensation paid must be reasonable.

Under the Act, the primary role of the board of directors is providing oversight by exercising corporate powers and managing the corporation's business and affairs. Typical duties of the board of directors include establishing corporate goals and policies, providing governance and accountability, overseeing officers and operations, approving budgets and finances, and maintaining constituent relations. The board of directors must also be knowledgeable about, and comply with, all applicable federal, state and local laws and regulations. In addition to the Sarbanes-Oxley Act provisions regarding destruction of documents and whistleblowers, Colorado law requires nonprofit corporations to keep minutes of all meetings of its board of directors, along with a record of any actions taken by the board without a meeting, as permanent records of the corporation. Consequently, whether acting as an individual or as a member of a board, directors are charged with specific duties and may be liable to the corporation or third-parties for failure to fulfill these duties.

c. Potential Liabilities and Risk Management

Under Colorado law, a properly formed nonprofit corporation is a separate legal entity that is usually solely liable under its corporate name for any of its debts and obligations. There are some instances, however, where the corporate form does not provide protection from liability.

As mentioned, directors and officers are required to exercise certain fiduciary duties and may become liable to the corporation if they are found to have breached one or more of these duties. For instance, directors may be liable to a nonprofit corporation if they vote

for or assent to an unlawful distribution or participate in or assent to a loan to an officer or director. Further, assent or participation in an improper conflicting interest transaction might also result in a director becoming liable to the corporation. A director may breach his or her duty of good faith through deliberate neglect of duties or failure to provide adequate disclosure to directors or members when seeking their approval of a transaction. Thus, a director's failure to make informed decisions, consistently attend board meetings, or complete required filings could, depending on the circumstances, all result in the imposition of liability.

Additionally, a court may disregard the corporate form and hold directors personally liable to *third parties* if there is a compelling inequity that might be set right by allowing the corporation's creditors or tort victims to recover assets from the directors. Thus, the corporate form does not likely protect a director or officer from liability arising from his or her own professional errors, omissions, or torts such as personal negligence, assault, slander or fraud. Similarly, a director is not protected from a violation of an obligation of law, such as compliance with certain Colorado wage claim statutes.

Colorado law provides several options for mitigating or eliminating director liability in some circumstances. As in most states, Colorado recognizes the business judgment rule, which provides a rebuttable presumption that a director's actions were in good faith and in the best interests of the corporation. This serves to reduce a director's potential liability to the nonprofit corporation by only requiring proof that a decision was "rational" rather than "reasonable." To fully take advantage of the business judgment rule in Colorado, a nonprofit corporation must include express provisions in its articles providing for lesser liability for its directors. Further, Colorado law provides directors and officers some relief from liability where decisions were based on reliance on information provided by other reliable parties. Regarding directors' personal liability to third persons, Colorado law provides directors and officers with some statutory relief. As mentioned above, the Act allows corporations to expressly limit or eliminate director's liability to the corporation or its members by so providing in the corporation's articles of incorporation. The Act also limits the personal liability of directors and officers for injury to persons or property arising out of the tortious acts of an employee of the nonprofit, unless the officer or director was personally involved in the situation or committed a criminal offense in connection with the situation.

Further, the use of volunteers, including volunteer directors, may pose a risk of liability for a nonprofit corporation. In addition to the federal Volunteer Protection Act's ("VPA") limitations on volunteer liability, Colorado has adopted statutory provisions protecting volunteers from liability if the action was within the scope of their volunteer duties, not willful or wanton, and did not cause harm to a third party. However, neither the VPA nor Colorado law works to shield the nonprofit corporation itself from vicarious liability

arising from the actions of its volunteers. Further, Colorado and federal law provides immunity from liability to directors and officers of nonprofit corporations who are volunteers under certain circumstances.

Other options for reducing or eliminating liability include indemnification, insurance, and liability waivers. The Act allows a nonprofit organization to indemnify a director, officer, fiduciary or agent for most civil liability arising out of that person's service on behalf of the nonprofit by providing this right in its articles of incorporation. Further, under Colorado law, a nonprofit organization may purchase and maintain insurance covering liability asserted or incurred against directors or officers. Finally, nonprofit corporations may attempt to reduce risk exposure by requiring volunteers and, to the extent applicable, the recipients of, or participants in, its services, to sign a waiver or release of claims.

4. Resources

- ABA Coordinating Committee on Nonprofit Governance, Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley (American Bar Association, Section of Business Law, 2005).

- "Form 990 Filing Tips: Governance (Part VI)" http://www.irs.gov/charities/article/0,,id=211125,00.html

- "IRS Training Materials-Governance" http://www.irs.gov/charities/article/0,,id=208545,00.html

- Governance and Tax-Exempt Organizations – Examination Materials http://www.irs.gov/charities/article/0,,id=216068,00.html

- Jacobs, Jerald A., Association Law Handbook, Fourth Edition: A Practical Guide for Associations, Societies, and Charities (ASAE & The Center for Association Leadership, 2007).

- Leaffer, Karen E., Guide for Colorado Nonprofit Organizations (Colorado Bar Association, Continuing Legal Education in Colorado, 2007).

- Overton George W. and Carmedelle Frey, Jeanne, Editors, Guidebook for Directors of Nonprofit Corporations, Second Edition (American Bar Association, Section of Business Law, Committee on Nonprofit Corporations, 2002).

- The Sarbanes-Oxley Act and Implications for Nonprofit Organizations (BoardSource and Independent Sector) (2003 updated 2006).

- U.S. Office of Personnel Management, CFC Glossary, *available at* www.opm.gov/cfc/html/glossary.asp.

- “Ellis Carter's Top 10 Non-profit Governance Mistakes (And 5 More)” Nonprofit Law Blog, http://www.nonprofitlawblog.com/home/2009/09/ellis-carters-top-10-nonprofit-governance-mistakes-from-a-lawyers-perspective.html