

Client Alert: The New District of Columbia Nonprofit Corporation Act of 2010 Takes Effect on January 1, 2012 – Are Your Governance Documents in Order?

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Earlier this year, the Mayor of the District of Columbia signed into law the new District of Columbia Nonprofit Corporation Act of 2010 (the “New Act”). The New Act is nearly 100 pages in length and represents an overhaul of the existing nonprofit corporation law in the District of Columbia (the “Old Act”), which had remained virtually unchanged since 1962. The New Act takes effect on January 1, 2012 and will be, with very limited exceptions, immediately applicable to all District of Columbia nonprofit corporations.

The New Act codifies many areas of nonprofit law not previously addressed under the Old Act, deviates from a number of provisions currently in place under the Old Act, and in many instances permits nonprofit corporations to elect much broader powers and flexibility within their internal governance structures than currently allowed under the Old Act. In light of the changes that will soon take effect under the New Act, all District of Columbia nonprofit corporations should re-examine their governance documents and internal policies and procedures to determine whether any provisions therein run afoul of the New Act or may be revised or supplemented to take advantage of the benefits offered under the New Act.

Included below is a brief discussion of some of the most notable changes that will take effect on January 1, 2012 under the New Act.

1. Standards of Conduct. The New Act codifies the standards of conduct that all directors and officers of nonprofit corporations must adhere to when acting on behalf of the corporation, namely the duties of good faith, care and loyalty. These standards had previously been recognized by District of Columbia courts but never statutorily expressed in the Old Act. Under the New Act, these standards are set forth in great detail and should be used by directors and officers as a roadmap for performing in their respective fiduciary capacities on behalf of the corporation. The New Act also sets forth the specific

instances in which a director or officer may rely on information provided by others and when he or she must disclose material information about the corporation not known to other directors or officers. Further, the New Act sets forth the procedures that should be followed by directors and officers with respect to competing business opportunities and conflict of interest transactions. It should be noted, however, that with respect to District of Columbia nonprofit corporations determined by the IRS to be exempt from federal income taxation, the New Act's provisions for such transactions are not as stringent as those required under current IRS regulations and, therefore, such organizations should take great care when deciding to what extent, if any, their existing internal policies and procedures may be amended without jeopardizing their tax-exempt status.

2. Limitations on Liability. The New Act includes a number of provisions that limit the personal liability of directors and officers. For example, non-charitable nonprofit corporations may now include in their articles of incorporation a provision that eliminates directors' and officers' personal liability for money damages to the corporation or its members except for instances involving improper financial benefits, intentional infliction of harms, unlawful distributions or intentional violations of criminal law. With respect to charitable nonprofit corporations, this same elimination of liability will apply whether or not the corporation amends its articles of incorporation to include a provision with respect thereto. Importantly, the New Act also carries forward from the Old Act those provisions that further limit or cap the liability of volunteers and employees of nonprofit corporations.

3. Indemnification. Perhaps the greatest changes under the New Act are the numerous provisions with respect to indemnification, advancement of expenses and obtaining insurance to protect directors and officers from personal liability. The Old Act was unclear as to the extent in which directors and officers could seek financial protection from the corporation if sued in their official capacities. Under the New Act, a nonprofit corporation may adopt a number of provisions into its governance documents with respect to mandatory indemnification, permissive indemnification, advancement of expenses and providing of insurance to directors and officers. District of Columbia nonprofit corporations should consider whether to amend their governance documents to address these topics.

4. Provisions Applicable to the Board. The New Act contains a number of new provisions that boards of directors of District of Columbia nonprofit corporations should consider, including:

a. Maximum Terms. Under the New Act, the maximum single term that a director may be elected to is five (5) years. Directors may, however, be re-elected to additional terms without limitation.

b. Director Proxies Not Authorized. The New Act permits directors to act either through presence and voting at a board meeting or by unanimous written consent in lieu of such meeting. Under the New Act, presence at a board meeting includes both presence in-person as well as by remote communications permitting all directors at the meeting to simultaneously hear each other. The New Act does not, however, expressly permit directors to assign by proxy their right to be present and/or to vote at board meetings or to consent in writing to board action in lieu of board meetings. Legal commentators on corporate law generally, as well as those familiar with the drafting and enactment of the New Act, believe that the New Act's silence on the use of director proxies should be interpreted as a prohibition against such use, and that the use of board proxies going forward would be inconsistent with the duty of care that directors owe to

the corporation under the New Act. This conclusion is consistent with the broadly accepted legal principal that director proxies are prohibited and may not be used unless expressly authorized by the nonprofit corporation law of the state in which a corporation was incorporated. As such, the use of director proxies should not be authorized under a District of Columbia nonprofit corporation's governance documents or otherwise permitted after the New Act takes effect.

c. Creation and Appointment of Board Committees; Restrictions on Committee Powers. Under the New Act, the creation of and appointment of directors to any board committee (regardless of whether or not such committee is granted the right to act on behalf of the entire board) requires the affirmative vote of a majority of all directors then in office. This is different than under the Old Act where only the creation of and appointment of directors to board committees with the power to act on behalf of the board (e.g., an executive committee) required a vote of a majority of all directors. Additionally, under the New Act, there are certain board powers that cannot be delegated to any board committee, including the power to: (i) adopt, amend or repeal bylaws, (ii) fill vacancies on the board or on any board committee, (iii) authorize distributions, or (iv) with respect to membership nonprofit corporations, take any action that the New Act requires the members to approve.

d. Creation of a "Designated Body". The New Act introduces the concept of a "designated body" and permits a nonprofit corporation to provide in its articles of incorporation or bylaws for the assignment of certain specific board powers to an individual or group (other than a board committee). Importantly, the New Act does not require that the individual(s) on the "designated body" be directors, officers or members of the corporation. The assignment of board powers to the "designated body" will have the effect of abrogating from the board all authority, responsibility and fiduciary duties related to such powers and vesting such authority, responsibility and fiduciary duties to those on the "designated body". This mechanism may be desired, for example, by certain nonprofit corporations seeking to vest perpetual control over one or more issues in a small number of individuals (e.g., the founders of the organization) instead of with the board of directors. Great care, however, should be taken by tax-exempt organizations seeking to implement such a "designated body" structure into their governance documents, as the IRS has long taken the position that certain material changes to a tax-exempt organization's organizational structure can result in a loss of its tax-exemption and require the submission of a new tax-exempt application.

5. Provisions Applicable to Members. There are also a number of new provisions set forth in the New Act with respect to membership nonprofit corporations, including:

a. Change in the Definition of "Member". Under the Old Act, a "member" of a membership nonprofit corporation was broadly defined to include any individual having membership rights under the corporation's articles of incorporation or bylaws. The New Act, however, changes the definition of "member" to include only those individuals who are granted voting rights under the articles of incorporation or bylaws with respect to director elections and certain major transactions (e.g., amendments to governance documents, mergers, sale of assets, dissolution, etc.). As such, only voting members will qualify as "members" under the New Act and be entitled to the default membership rights granted thereunder. This change could be problematic for nonprofit corporations whose governance documents provide for one or more classes of non-voting members but rely on the default provisions

currently contained in the Old Act with respect to such non-voting members' membership rights in the corporation (e.g., the right to attend meetings, inspect books and records, etc.). To address this problem, the New Act contains a carve-out that allows membership nonprofit corporations to expressly set forth in their articles of incorporation or bylaws the specific rights that non-voting members have with respect to the corporation notwithstanding the fact that they do not qualify as "members" under the New Act. Unless such rights are contained in a corporation's articles of incorporation or bylaws, the non-voting members of such corporation will not be entitled to any of the default membership rights provided under the New Act.

b. Member Meetings and Voting. The New Act contains a number of default provisions with respect to the calling of member meetings, notice, quorum and voting requirements, some of which differ from those provisions set forth under the Old Act (e.g., meetings called by members will now require 10% of members instead of 5%, notice can now be given up to 60 days in advance of member meetings instead of up to 50 days in advance, membership lists must now be prepared and maintained by the corporation and available for member inspection, and a quorum at member meetings now requires the presence of those members representing a majority of all votes entitled to be cast instead of 10% of such votes). Membership nonprofit corporations should review their governance documents to determine whether revisions need to be made to adopt or alter the default provisions provided under the New Act.

c. Delegates. The New Act introduces the concept of "delegates" and allows the members of nonprofit membership corporations to elect or appoint delegates to vote in director elections or on other matters requiring a vote of the members. A nonprofit membership corporation wishing to utilize delegates must ensure that provisions relating to such delegates (e.g., how appointed and removed, voting requirements, etc.) are included in the corporation's articles of incorporation or bylaws.

d. Removal of Directors. The New Act will now permit members of a membership nonprofit corporation to remove directors with or without cause unless the corporation's articles of incorporation or bylaws provide that members may only remove directors for cause and set forth the grounds that will constitute a cause for removal.

e. Member Liability to Creditors of the Corporation. The New Act expressly recognizes that members of a nonprofit membership corporation will not be liable for the debts owed by the corporation except in the event that a judgment against the corporation remains unsatisfied and there are outstanding membership dues owed to the corporation. In such case, a member can be held personally liable on the judgment against the corporation to the extent of such member's outstanding dues.

6. Restating Articles of Incorporation. The New Act will permit a nonprofit corporation to restate its articles of incorporation in their entirety. This procedure will allow a corporation to consolidate all of its previous amendments to the articles of incorporation into one succinct document and, at the same time, include any new provisions to the articles necessitated or permitted by the New Act.

In addition to the above, District of Columbia nonprofit corporations determined by the IRS to be exempt from federal income taxation should remain vigilant for future possible IRS regulations regarding organizational and governance matters, as such regulations could impose further requirements on organizations to maintain their tax-exempt status.