All state statutory and case law holds that directors of nonprofit, 501(c)(3), corporations must serve as stakeholder (owner) agents, acting in ways that protect and advance their interests. Legalities aside, this is the foundation of great governance. In order to fulfill this obligation, directors must discharge three legal fiduciary duties: loyalty, care and obedience. Directors of healthcare organizations are individually/collectively accountable for being loyal, careful and obedient, and are liable if they are not.

Key Concepts: Owners/Stakeholders

All organizations have owners; they are called stockholders\(^1\) in commercial corporations and stakeholders in nonprofits. Boards are accountable to an organization’s owners, representing them and acting in their behalf; they are agents. Boards must ensure an organization’s resources and capacities are deployed in ways that maximize owner benefit.

While stockholders and stakeholders are (in many ways) equivalent, there are some significant differences:

<table>
<thead>
<tr>
<th>stockholders in tax-paying organizations</th>
<th>stakeholders in tax-exempt organizations</th>
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<tbody>
<tr>
<td>stockholders have a divisible financial interest in the organization represented by shares of stock; if the organization were sold, residual net equity would be distributed to stockholders on a pro-rata basis</td>
<td>stakeholders are a collective the organization is designed to benefit and whose interests must be protected/advanced; members of this general class do not have a divisible financial interest in the organization; if the organization were sold, individual stakeholders would not receive</td>
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\(^1\) Governance history: Until the mid-1800s most organizations were small and easily capitalized by their individual owners. With the onset of the industrial revolution very large organizations emerged that required huge investments. Funds were acquired by selling stock. Stockholders required a mechanism to ensure that organizations would be operated for their benefit. Boards, serving as owner agents, were created to fulfill this function.
stockholders are easily identified; those who have purchased shares of stock and are listed by the organization’s registered agent

a commercial corporation’s stockholders want about the same thing; wealth enhancement

stakeholders are typically vaguely defined in the organization’s charter and bylaws (e.g., for a hospital, “the community”)

various stakeholder groups of nonprofit organizations generally want very different things that often conflict with one another

Differences between stockholders and stakeholders complicate nonprofit organization governance and increase the challenges boards face in fulfilling their fiduciary duties (particularly loyalty).

The Duty of Loyalty

The fiduciary duty of loyalty requires that directors, in performing their roles, owe allegiance to the organization’s stakeholders; acting in their best interest rather than for personal gain or the benefit of other organizations, groups and individuals. All dealings, actions and decisions of directors in their official capacity must meet two requirements. First, they must have good faith intentions; manifesting a genuine desire to discharge their responsibility to advance and protect stakeholder interests. Second, they

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2 Residual net equity would have to be allocated to charitable purposes. For example: if a nonprofit hospital were sold to a for-profit corporation, the proceeds might be placed in a nonprofit community benefit foundation.

3 Some nonprofits are owned by other nonprofit organizations (so called “sole corporate members”). For example: a nonprofit health system might own, and be the sole corporate member of, several nonprofit hospitals. If a subsidiary hospital was sold, proceeds would revert to the system.

4 Because of this, nonprofit organization boards must identify key stakeholders; those groups the board must represent and to whom it is accountable.

5 Key stakeholders of a nonprofit hospital might include (to cite only a few examples): members of the community who are un- or under-insured; members of the community who have full coverage health insurance; members of the medical staff; and employees. Each of these groups define the benefits they want from, and expectations they have of, the hospital in very different ways. Here’s another example: The stakeholders of a nonprofit condominium are individuals who own units. However, this general class is composed of, at least, two stakeholder groups: owners who live in their units; and those who rent them out. Each group has different needs/expectations.
must behave in ways that demonstrate reasonable belief their decisions/actions are in stakeholders’ best interest.

Directors breach their duty of loyalty when, for example: a material conflict-of-interest influences their decisions; they disclose confidential information that could have a detrimental effect on the organization; they seize a business opportunity for themselves or other parties that legitimately belongs to the organization; they vote for, or ascribe to, an unlawful distribution of the organization’s assets (which subverts its charitable purpose and/or results in private inurement).

For directors to discharge their fiduciary duty of loyalty, the board on which they serve must, as a foundation, undertake a stakeholder analysis: specifying/identifying key stakeholder groups and developing a fine-grained and precise understanding of these stakeholders’ needs/expectations. It is impossible to be loyal if directors do not know: (1) definitively/precisely the parties who the board represents; and (2) what benefits these parties want from, and expect of, the organization.

Some illustrations of how directors can demonstrate loyalty are:

✔ obtaining instruction regarding this duty during new director orientation programs, followed up by annual educational sessions

✔ keeping key stakeholders, their interests and community benefit as foreground when discussing, deliberating and voting on issues coming before

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6 A description of the methodology for undertaking a stakeholder analysis is beyond the scope of this Center Tool.

7 When conducting board retreats, and after discussing the concept of stakeholder, I often ask directors to take out a sheet of paper and list their organization’s most important ones. What I typically get are vague/general descriptions (e.g., the community, patients) or specifics that vary widely from director to director.
Always ask (and encourage board colleagues to consider): What is in the best interest of key stakeholder groups?

- disclosing all potential material conflicts-of-interest in an annual statement filed with the organization and updating it during the year when warranted
- with respect to specific issues coming before the board, acknowledging any potential conflicts-of-interest and seeking an opinion as to their materiality
- if a material conflict-of-interest is judged to exist, totally removing oneself from discussing, deliberating, exercising any influence regarding, and voting on the issue
- raising questions regarding the potential conflicts of other directors, when warranted
- never talking with outsiders about information or matters deemed to be sensitive or confidential
- periodically, reviewing and discussing the fiduciary duty of loyalty and its implications for how the board goes about its work

Instruction regarding the duty of loyalty should be provided during new director orientation programs and periodically at board retreats.

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8 This is particularly important when the board considers “big deals” such as mergers, acquisitions, closure, sale of the organization or the disposition of major assets. The board must make decisions in such matters from the perspective of what is in stakeholders’ best interest.

9 Keep in mind that nonprofit organizations are MEANS, not ENDS unto themselves. They are constellations of resources/competencies created and maintained to benefit their owners. Thus, the board’s fundamental obligation is to ensure that organizational means fulfill stakeholder ends.
The Duty of Care

Directors are expected to take “due care” in performing their roles. They must be reasonable, diligent, prudent and demonstrate sound judgment; equal to that of an ordinarily competent person in similar circumstances in a manner he/she believes to be in the best interest of stakeholders (notice the overlap here with the duty of loyalty). The duty of care focuses on the process of acting and deciding, not results. The test: Is there evidence that reasonable care was exercised? The test is not: Was the result optimal, satisfactory or even tolerable? Directors can presume that information, analyses and recommendations provided by others (organizational executives/staff and consultants) are accurate, truthful and informed if there are no compelling reasons to believe otherwise. This duty does not require that directors be overly cautious, avoiding all risks. Courts are hesitant to substitute their business judgment, after the fact, for boards that did not have the benefit of such hindsight. The expectation is, simply, that directors act carefully with common sense and reasonable, informed judgment.

Some illustrations of how directors can demonstrate care are:

✔ coming to board and committee meetings prepared, having carefully reviewed agenda materials and proposals/recommendations up for discussion and vote

✔ asking for additional information and clarification when an issue is not understood

✔ demanding that an adequate amount of board time is spent on important issues

✔ asking the “tough questions”
The very best, and most helpful, questions are those that seek to clarify: alternatives that were considered and discarded (and why); what could go wrong if the proposal was implemented; and how the proposal effects, and furthers the interests of, stakeholders.

✅ challenging assumptions
All proposals are based on them, and they’re often implicit and fuzzy. Unclear, illogical or just plain wrong ones will sabotage proposals that look wonderful on the surface. Help to identify and defuse these “time bombs.”

✅ one must contribute to exercise due care; while participation does not equate to contributing, it is impossible to contribute without participating
Talking is the primary way boards accomplish their work. Speak up; share your ideas, perspectives, experiences and values.

✅ being prepared to express a dissenting opinion and vote “no”
Don’t be pressured by apparent overwhelming agreement. In light of the facts, after listening carefully to your colleagues, and taking a stakeholder perspective, vote your conscience. Often, the biggest governance mistakes are avoided because several directors were willing to go against the crowd. If you are the lone dissenter on an important vote, always share your rationale, making sure it is accurately summarized in the meeting minutes.

Instruction regarding the duty of care should be provided during new director orientation programs and periodically at board retreats.

The Duty of Obedience

Statutes denote, and courts hold, that directors have a duty of obedience;
avoiding *ultra vires* acts. Such acts are those beyond the legal authority of the board as articulated by federal/state laws, court decisions and regulations in addition to those specified in the board’s own articles of incorporation, charter, bylaws and policies. The duty of obedience requires directors to abide by the law and follow its own rules.

Some illustrations of how a board can help directors fulfill their duty of obedience are:

☑️ providing instruction regarding this duty during new director orientation programs, followed up by annual educational sessions

☑️ supplying directors with carefully crafted and easy to consume summaries of key laws, court decisions, regulations and their implications

☑️ seeking opinions from counsel regarding the applicability of key laws, court decisions and regulation to the board’s duty of obedience before dealing with important issues (e.g., mergers, acquisitions or the sale/disposition of assets)

☑️ codifying all board policies and circulating them to directors in a continually updated policy book

**Conclusion**

Legalities sometimes complicate that which is simple and straight-forward. Directors are stewards and hold the organization’s resources/capacities in trust on behalf of stakeholders and the community. As stakeholder agents they are obligated to have good intentions, be honest, exercise reasonable judgment and abide by the law and the organization’s own rules.

Faithfully discharging the legal fiduciary duties of loyalty, care and obedience
equate to directors doing their job and are cornerstones of good governance.