

Disclosure of Confidential Information by Directors:
Is There a Duty of Confidentiality and Should There Be?

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I. INTRODUCTION

As we all know, legal authority to manage (or direct management) of a not-for profit corporation is vested in the corporation's Board of Directors. To exercise such oversight effectively, Boards need to be informed. To be informed, Boards frequently need access to proprietary or other non-public information and need candid presentations and debate.¹

Board decisions generally do not need to be unanimous. Reasonable minds can differ on many, if not most, decisions. This basic tenet is the basis of the business judgment rule propounded by courts first in the context of business corporations and now generally accepted in the not-for-profit context as well. Still, boards can, and do, make bad decisions sometimes.

This paper considers the rights and responsibilities of individual members of the Board with respect to nonpublic information that they have learned in their capacity as Board members particularly when they disagree with the collective decision of the Board. One does not have to condone the actions of Hewlett Packard to be concerned by repeated release of proprietary information to the press by a Board member. However, with limited enforcement budgets for regulators in the charitable sector and repeated press reports of inattentive boards and egregious decisions that are only reversed after media attention, one must carefully consider any limitations on nonprofit transparency.

Part II of this paper briefly considers certain background concepts including what we mean by disclosure of confidential information, the functions of boards, the basic concepts of fiduciary obligations and the related statutes and case law as they relate to confidentiality. After finding in Part II that there has been no clear pronouncement of a

¹ Not-for-profit corporations use a variety of labels to refer to the members of the governing board, including "Director", "Trustee", "Overseer", "Governor", "Regent", "Member of the Board" and others. For simplicity, this paper uses the term "Board member" to refer to all of these labels. In addition, for purposes of this paper the term "Board member" is used only to refer to members of the governing board and not to include members of advisory boards, or members of committees who are not also members of the governing board itself.

duty of confidentiality by courts or legislatures to date, Part III considers whether there *should* be a duty of confidentiality and how far such a duty should extend.

The paper concludes in Part IV that if the law is to vest oversight responsibility for a nonprofit in the corporation's Board, the Board must have access to corporate information and thus there must be some meaningful assurance of confidentiality for such information. That being said, the nonprofit sector's repeated experiences with inactive Boards and insufficient oversight suggests that we may need certain narrow exceptions to this confidentiality. The trick is to make sure that the exceptions do not destroy the premise.

II. BACKGROUND

A. What Do We Mean By A Duty Of Confidentiality?

Before we begin our analysis, it is useful to spend a few lines considering what I mean by confidentiality. For purposes of this paper, I intend a duty of confidentiality to mean a duty not to reveal to third parties *nonpublic information that a Board member has been given or learned in his capacity as a Board member*. This may include corporate work product, information from oral presentations, and opinions expressed by corporate advisors, retained experts, and management. It also includes details of Board deliberations and opinions expressed by fellow Board members.

A duty of confidentiality is not an obligation to support or agree, privately or publicly, with actions taken by the organization or its Board. Some organizations do impose such a requirement on their board members, and such requirements have been upheld.²

Last May, a committee of the ACLU board that had been convened to consider the Board's governance procedures and the rights and responsibilities of Board members issued a report and proposed guidelines to the ACLU board. The proposed guidelines attracted a lot of attention and criticism and were subsequently withdrawn.³ The report included the following statement:

“Where an individual director disagrees with a Board position on matters of civil liberties policy, the director should refrain from publicly highlighting the fact of such disagreement, particularly where the purpose or principal effect of such publicity is to call into question the integrity of the process in arriving at the Board's decision....A

² *Phelan v. Laramie County Community College Board of Trustees*, 235 F.3d 1243 (10th Cir. 2000) (holding that censure of a Board member, pursuant to a policy that requires Board members to “abide by and support” decisions of the Board, for taking out an ad urging voters to vote against a tax assessment proposal put forth by the College does not violate free speech rights because censure did not prevent the speech).

³ See generally, Stephanie Strom, *ACLU May Block Criticism by its Board*, N.Y. Times, May 24, 2006; Stephanie Strom, *ACLU Warned on Rules to Limit Member's Speech*, N.Y. Times June 19, 2006; and ACLU press release dated July [], withdrawing proposal available on ACLU web site www.ACLU.org.

director may disagree with an ACLU policy position, but may not criticize the ACLU board or staff.”⁴

To be clear, the details of Board deliberations including positions taken by other Board members would be considered confidential information addressed by this paper, but criticism of the Board and staff based on the decision of a Board to take certain public positions would be expressions of opinion based on publicly available information that is beyond the scope of this paper.⁵ As discussed, below, however, sometimes decoding this distinction may not be easy.⁶

This paper does not address nonprofit entities that are subject to “open meeting” or similar laws or materials that may be subject to requests under the Freedom of Information Act due to the nature of the organization or the Board member (e.g. governmental representatives sitting on boards ex officio).

Finally, before we begin the analysis of a board member’s fiduciary obligations, it is important to remember that the decision by a Board member to disclose nonpublic information cannot be confused with a decision by the corporation to disclose the information. Nor can it be viewed as an action of the Board member in furtherance of his duties as a Board member. It is well established that a Board member acts for the corporation only through a legally constituted meeting of the Board or pursuant to an express delegation of authority by the corporation.⁷

B. The Job Of A Board Member – Statutory And Case Law Framework.

1. Functions of the Board. We begin this analysis by quickly reviewing the functions of the Board and its members and the standards of conduct required in the exercise of those functions. As we all know, state statutes generally provide either that: (1) The affairs of the corporation shall be managed by its Board of Directors,⁸ or (2) The affairs of the Corporation shall be managed under the direction of

⁴ Committee on Rights and Responsibilities of Board Members Report dated May 18, 2006 p.13. The full report is available on the ACLU website, www.ACLU.org. [find document url].

⁵ Before making public statements, Board members should take into account that, even with respect to matters of public record, public disagreements among board members played out in the media can hurt an organization. Guidelines governing the appropriateness of such public statements, however, are beyond the scope of this paper.

⁶ To avoid confusion, it is a good idea for nonprofit managers to add legends on materials they consider to be confidential whenever possible to notify or remind board members of the organization’s expectations.

⁷ See N.Y. NPCL s.708; Bayer v. Beran, 49 N.Y.S. 2d 2,11 (1944); Restatement Third Agency s. 101.

⁸ See e.g., N.Y. NPCL s701.

its Board.⁹ Thus it is said that Boards exercise oversight responsibility over management of a not-for-profit-corporation.

Important aspects of this oversight responsibility include: establishing goals, objectives and policies; appointing senior professionals and monitoring their work; and deliberating and taking action on fundamental changes to corporate structure, strategy and operations or other major corporate transactions.¹⁰ In the not-for-profit context, the Board serves as the only significant legal check on the actions and discretion of management in not-for-profit corporations other than enforcement actions by regulators.¹¹

All of these responsibilities require access to nonpublic information. If Board members are not informed of significant transactions, new directions, management and legal compliance issues, they cannot effectively exercise oversight. To be appropriately informed, Board members must understand both the objectives and the risk factors, the pros and cons, of any proposed action. As not-for-profit corporations grow larger and more sophisticated, Boards must increasingly rely on candid presentations by professional management to empower Boards to exercise that oversight responsibility. It is difficult to expect management to be open and candid about its plans and potential risks of those plans, if they are not confident that such information will remain confidential.

2. Standards of Conduct by Board Members. It is well known that a Board member of a not-for-profit corporation has a fiduciary obligation to the corporation. This obligation includes both the duty of loyalty and the duty of care; some commentators also refer to a duty of obedience.

(a) Duty of Loyalty. The most likely source for a duty of confidentiality is within the doctrine of the duty of loyalty. State laws describing the duty of loyalty generally consist of a set of provisions addressing conflict of interest transactions and a list of specific transactions in which an entity may not engage.¹² The duty of loyalty is also found in the requirements that a director act

⁹ RMNCA s 8.01. Depending on state law, the Certificate of Incorporation may provide for exceptions to this general allocation of management authority to the Board.

¹⁰ Certain state statutes also provide certain specific responsibilities such as appropriation of investment gain or loss and approval of sales and leases of real estate.

¹¹ In the business corporation context, shareholders have standing to sue and thus also operate as a legal check on management authority. Not-for-profit corporations obviously have no shareholders. Although many state statutes provide for NFP's to have "Members" who are given many of the governance rights of shareholders, most not-for profit corporations do not have "members" as defined in the statutes. Of course, it can also be argued that the limited checks on nonprofit management discretion make the role of the press even more important in the nonprofit context.

¹² See e.g., N.Y. NPCL s715-716; Revised Model Nonprofit Corporation Act (RMNCA) s.830 promulgated by the American Bar Association 1987.

in “good faith” and in a manner that he “reasonably believes to be in the best interests of the corporation.”¹³ The duty of loyalty “requires the director’s faithful pursuit of the interests of the organization he serves rather than the financial or other interests of the director or another person or organization.”¹⁴

While much of the law about duty of loyalty relates to financial transactions between a corporation and a board member or related party, there are also several areas that involve the use of corporate information or position by a Board member. For example, it is clear that a Board member may not use nonpublic information to make a profit.¹⁵ Similarly, a Board member clearly may not use nonpublic information to usurp a corporate opportunity. A board member also may not use his position to benefit another charity at the expense of the nonprofit on whose board he serves.¹⁶

The hypotheticals in Part III.A. below give examples of the damage that disclosure of nonpublic information may do. Conceivably these injuries could form the basis of claim for a breach of the duty of loyalty. In addition, nonprofit organizations routinely worry that public airing of internal disagreements will erode public support and thus donor support for the organization.¹⁷ Thus an argument could be made that airing corporate disagreements publicly can never be in the best interests of the corporation. Of course where the disclosure is made by a dissenting director to cause the corporation to act as the dissenting director believes is responsible, the dissenting director would argue that the disclosure is both in good faith and in the best interests of the organization and thus not a breach of the duty of loyalty.¹⁸ This dichotomy of perspective may be particularly difficult to resolve in the nonprofit sector where the best interests of the organization may not be measured in financial terms.

¹³ RMNCA s8.30(a)(3).

¹⁴ Kurtz, Board Liability, (1988) at 21.

¹⁵ See e.g. *Diamond v. Oreamuno*, 24 N.Y. 2d 494 (1969) (Board member could not use nonpublic information regarding profits to profit from sale of stock).

¹⁶ *Brown v. Memorial National Home Foundation*, 162 Cal. App. 2d 513 (1958).

¹⁷ It would be useful to study correlation between press reports of internal disagreements or disarray and fundraising success compared to general trends in the same sector for the same period. Even without a detailed study, however, nonprofit managers are convinced there is a close and immediate connection. The strength of this belief alone is sufficient to affect the manner in which nonprofit executives handle confidential information and their Boards.

¹⁸ Obviously, such a defense is not available to Board members whose disclosure of nonpublic information is not an act of dissent.

My research to date has uncovered no cases addressing whether there is a breach of the duty of loyalty through the use of nonpublic information by a Board member where no benefit accrues to the Board member or other entity.

(b) Duty of Care. The duty of care generally requires a Board member to act in good faith with “the same degree of diligence, care and skill” which an “ordinarily prudent” person would exercise in “similar circumstances in like positions”.¹⁹ This generally includes the duty of attention and the duty to be informed. It is generally accepted in most jurisdictions at this point that in determining whether there has been a breach of the duty of care in the not-for-profit context, the “business judgment” rule developed in the corporate arena will be applied. That is, where there has been good faith and due diligence, decisions of the board will not be second guessed or viewed through the prism of hindsight.²⁰

As with the duty of loyalty, my research has revealed no cases that address the application of the duty of care to disclosure of nonpublic information. The principles behind the duty of care, however, suggest great deference to good faith decisions of the Board. Indeed, as long as the duty of care is satisfied, a Board is afforded wide latitude in its actions.²¹ Implicit in such a rule is an acceptance of good faith errors in judgment by the Board. This acceptance is relevant to the consideration in Part III below of when exceptions to confidentiality should be permissible.

(c) Duty of Obedience. Some commentators have described a third duty of Board members -- the duty of obedience. The duty of obedience is essentially a duty to abide by and further the mission and charitable purposes of the organization and to ensure compliance with law.²² Some commentators prefer to view these duties as part of the duty of care. Regardless of whether the duty of obedience is a separate fiduciary duty or part of the duty of care, it would not seem to be breached by disclosure of nonpublic information. It might be used, however, as the basis of an argument to authorize such disclosure in certain contexts. For example, where a dissenting board member feels that the action of the Board is so fundamental that it calls into question the integrity of the

¹⁹ N.Y. N-PCL s.717. A similar standard is provided in the RMNCA s.8.3. The RMNCA, however, includes in its formulation a third requirement which is that the Board member act in a manner that he reasonably believes is in the best interests of the corporation.” This formula overlaps with the standard formulation of the Duty of Loyalty discussed above. See also, *Stern v. Lucy Webb Hayes National Training School*, 381 F. Supp 1003 (D.C.D.C. 1974).

²⁰ See *New York Credit Men’s Adjustment Bureau v. Weiss*, 305 N.Y. 1 (1953); *Abrams v. Allen* 297 N.Y. 52 (1947); *Casey v. Woodruff*, 49 N.Y.S. 2d 625 (1944).

²¹ *Weiss v. Opportunities v. Cortland County*, 40 A.D.2d 45 (1972); *Central N.Y. Bridge Ass’n v. American Contract Bridge League, Inc.*, 339 N.Y.S.2d 438 (1972)

²² See Fishman, *Nonprofit Organizations Cases and Materials*, 3rd Ed. (2006) 219-222.

organization's charitable purpose or its legal compliance obligations, an exception to a duty of confidentiality may be sought. I am unaware, however, of any cases that would suggest that the business judgment rule would not apply to issues involving the duty of obedience as long as good faith and due diligence were adhered to.

III. SHOULD THERE BE A DUTY OF CONFIDENTIALITY?

In the absence of clear statutory provisions or case law, we turn to the normative question of whether there should be a duty of confidentiality. To answer this question, we begin with a series of hypotheticals which seek to explore what purposes are served by confidentiality (III.A.) and what costs result from it (III.B.). Next, Part III.C. considers what alternatives there are to disclosure for a dissenting Board member; III.D. and E consider the analogous areas of standing to sue and attorney client privilege. III.F considers various attempts to distinguish types of content for disclosure purposes, and Part III.G. concludes the section with consideration of different types of Board members.

A. Benefits of Confidentiality.

Example 1. Attorney/Client privilege. After making certain changes to its policies and procedures, Nonprofit is sued. Nonprofit's counsel presents a detailed written report on the allegations, Nonprofit's proposed litigation strategy and its likelihood of success. Board member who believes that the changes that were made represent a significant unwelcome departure from Nonprofit's history and mission, provides a copy of the report to the press.

Example 2. Contractual Confidentiality Agreement. Nonprofit decides to terminate the employment of its Executive Director. The parties enter a severance agreement in which ED agrees to resign and to waive all legal claims in exchange for a severance amount and a promise of confidentiality about the circumstances surrounding his resignation. The Board reviews and approves the severance agreement. When a reporter calls Board Member to investigate why ED is leaving, Board Member reveals all of Nonprofit's dissatisfactions with ED. ED sues Nonprofit.

Example 3. Premature Disclosure/Policy Disagreement. Services Organization is given the opportunity to negotiate privately with City to open a facility on City owned property which will provide a significant new class of services. After extended discussion, the Board authorizes the Executive Director to pursue the expansion over the dissent of several board members who believe the new services and facility will distract Services Organization from its core mission. After a leak by one of the dissenting members criticizing the proposal and revealing the proposed location, there is immediate neighborhood opposition to the facility and City withdraws from the negotiations.

Example 4. Premature Disclosure/Competition. Cultural Organization A develops a very new and noteworthy program idea which requires collaboration with Wealthy Institution. With the consent of its Board, Cultural Organization A invests significant time and effort to promote the collaboration in confidence with the leadership of Wealthy Institution in preparation for the signing of a collaboration agreement. Board Member of Cultural Organization A casually mentions the exciting new idea to a friend who repeats it to Cultural Organization B. Cultural Organization B approaches Wealthy Institution with a similar proposal in direct competition with Cultural Organization A.²³

Example 5. Leadership Issues. Nonprofit has undergone several years of financial difficulty and several failed strategies to address those difficulties. As part of its regular governance process, Nonprofit's Board conducts a confidential appraisal of the Executive Director each year. During this process, certain Board Members express the view that Nonprofit needs new leadership. However, after discussion, Board votes to renew the Executive Director's contract. Shortly thereafter, a detailed description of the Board's concerns appears in the press. Nonprofit's fundraising for the next 6 months hit record lows.

Example 6. Internal Investigations. Nonprofit hires a new Chief Financial Officer. The new CFO conducts an internal audit of Nonprofit's accounting policies and discovers lax policies and procedures with regard to account reconciliations, accounting for restricted gifts and expense reimbursements. CFO reports the results of his audit to Nonprofit's audit committee along with a timeframe for correction of the problems. Board Member, who is generally critical of Nonprofit's CEO, reveals the problems to the press, citing them as evidence of CEO's inadequacy. Board Member fails to mention the corrective steps being taken.

Examples 1-6 provide legitimate and compelling examples of nonpublic information that needs to be shared with Board member to enable appropriate oversight but that should remain confidential. Examples 1 – 4 cite specific damages that may result from disclosure (waiver of attorney/client privilege, action for breach of contractual confidentiality clause, and loss of corporate opportunity). In examples 5 and 6, the damage is more indirect. As discussed in footnote 17 and the related text. The damage is two-fold. First there is the perceived damage to public confidence and donor support that is said to arise from the public airing of internal disputes. More important from my perspective is the danger that those exercises (candid evaluation of leadership issues and voluntary internal investigations) either will not be conducted as candidly or will not be shared with Board members at large if confidentiality may not be presumed.

²³ Theoretically, an argument can be made that in the nonprofit sector, there is no such thing as a competitor. After all, if all organizations exist solely to serve the public, it should not matter which organization succeeds in providing that service. While this common objective may lead to greater collaborative spirit within the nonprofit sector, a nonprofit board that is charged with acting in the best interests of the corporation must still be expected to protect the corporation's intellectual property, resource investments and fundraising potential.

In each of these examples, if the disclosure is made by a dissenting shareholder, it would appear to be an effort to force the majority to reverse itself. As discussed in Part II.B.2.b., above, however, our system of governance of nonprofits presupposes both a significant confidence in the acts of a Board majority and an acceptance that errors in judgment may be made. Given the numerous examples of damage caused in the nonprofit sector by charismatic but secretive management or domineering individuals who control the Boards they lead without discussion or questions, it would be a significant error to provide a justifiable reason to conceal material information from board members. Accordingly, there must be a mechanism to keep the Board informed without risking making the underlying information available to the public.

The Draft ALI Principles of the Law of Nonprofits (“ALI Nonprofit Law Principles”) s. 340(b) addresses this need as follows: “[a board member] must preserve, except as may be required by the organizational documents or board policy, the confidentiality of information that the board member knows or has reason to know is confidential....”²⁴ Exceptions to this rule included by the ALI drafters are described below.

B. Costs of Confidentiality.

(1) Whistle Blower/Legal Compliance

Example 7. Following allegations of impropriety in Nonprofit’s expense reimbursements, financial reporting and hiring practices, Board Member A requests an investigation. Board President and other prominent Board members dismiss the allegations, refuse further investigation and become hostile to Board Member A. After learning that certain of the allegations relate to conduct by Board President and Nonprofit’s CEO, Board Member A and a few other board members request an independent investigation. When the Board narrowly approves the investigation, Board President appoints a committee of supporters and excludes all directors who had requested the audit. After repeated delays and several months, a draft audit report is prepared but Board Member A and others outside the small committee are refused copies of the report or the engagement letter and told that revisions need to be made. When copies of the report and engagement letter are finally released to the full Board, questions are raised about the adequacy of the engagement. Nonetheless, Board rejects further investigation. Only after newspaper articles reveal that management had received a report several months earlier validating certain of the allegations does the Board take action. Subsequent investigation leads to criminal conviction of former executive director for misappropriation of \$1.5 million of corporate funds through unauthorized pension payments and expense reimbursements.

The facts of Example 7 are based on the well known scandal at United Way where a minority of Board members made repeated attempts to get United Way to

²⁴ ALI Principles of the Law of Nonprofit Organizations Council Draft no. 4 s.340(b).

investigate the allegations itself. For whatever reason, however, cronyism, misplaced trust and loyalty, relationships based on good will and superficial involvement, lack of time or inclination, a majority of the Board resisted asking questions or second guessing management and allowed a few to vehemently discourage those who did ask questions. Indeed, those who did were ultimately not reelected to the Board by their peers.

Unfortunately, there have been enough scandals in the nonprofit sector, to tell us that United Way is not a sole exception to appropriate Board oversight.²⁵ In such a context, where alleged violations of law (including violations of the duty of loyalty) are at stake and substantial internal efforts to induce the Board to address the issue have been rebuffed, disclosure of confidential information may be appropriate.

Even in this context, however, it is worth noting that not all disgruntled Board members are correct and not all allegations are true. At times it may be reasonable for an attentive Board to conclude that investigation has been sufficient and that allegations are unfounded. Moreover, media exposes that rely on incomplete or one sided reports of complicated issues may be deeply damaging. In addition, as discussed above, even responsible management and board leaders acting in good faith may be tempted to conceal difficult issues from all but the most loyal board members if they cannot rely on disgruntled Board members to keep information confidential to the extent appropriate.

To balance the compelling interest in legal compliance with the damage that can be caused if the dissenting director's assessment of the situation is wrong, the Draft ALI Nonprofit Law principles include an exception to the duty of confidentiality described as follows: "the board member may in good faith disclose to the attorney general or other regulator or to a court confidential information that he or she reasonably believes appropriate to prevent, mitigate or remedy harm to the charity."²⁶

2. Maintenance of Ethical Guidelines/Best Practices and Internal Policy Disputes.

Example 8. Museum curators announce to Museum's Board that they want to mount an exhibition of a particular school of artists and that Board member A, who is a substantial collector of a particular artist within that school, agrees to loan several works to the exhibition and to fund the exhibition and several other projects, on the condition that his contribution be anonymous. Without the participation of Board Member A, the Board of Museum reviews the agreement, determines that Board Member A had no material involvement in the proposal to mount the exhibition and will have no involvement in the selection of works, and approves the gift agreement. Board Member A has made several previous anonymous contributions to Museum as well. Nonetheless, Board Member B

²⁵ Examples 5 and could also have fit this pattern if they had included allegations of illegal conduct by senior management (as the reason for termination of the Director or as part of the audit) that the Board failed to address.

²⁶ ALI Nonprofit Law Principles Draft no. 4 s.340(b).

reveals the details of the gift to the press which runs an article criticizing Museum for accepting the gift and mounting the exhibition which further Board member's interests.

Since the controversy surrounding the *Sensations* exhibition at the Brooklyn Museum, best practice guidelines have been issued within the museum community discouraging anonymous gifts that serve to conceal conflicts of interest. Violation of these best practices is not violations of law but nonetheless represent a disavowal of important policy considerations. Similar attempts at self-regulation exist throughout the nonprofit sector. Because such guidelines often rely on self-policing, however, the media plays a particularly important role in such areas.

Example 9. Advocacy Organization's mission is to protect free speech. Advocacy Organization wishes to raise funds through a federally administered program. As a condition of participation in such program, Advocacy Organization would be required to certify that it has screened its employees against a federal "watchlist". Advocacy Organization's Executive Director agrees to participate without consulting the Board. When such participation comes to the attention of the Board, some board members request immediate retraction on the grounds that participation was in fundamental conflict with the organization's free speech mission. Board does not vote for immediate retraction. Advocacy Organization's use of the watchlist subsequently is reported in the press. Advocacy Organization quickly moves to withdraw its participation. Board members disagree as to whether Board's initial inaction was based on a desire to study the issue further or a lack of concern over the issue.

In both examples 8 and 9, Board members disagree over an issue that is a matter of internal practice or operations policy. In this regard, they are similar to the disagreements underlying examples 1 – 7. As with examples 5 and 6, the damage that would result from disclosure is the indirect damage of erosion of public support and chilling effect on nonprofit management's willingness to share nonpublic information.

Like example 8, the issue in example 9 is considered by the dissenting Board member to be of particular importance to the credibility and mission of the organization (and perhaps to the Board's duty of obedience). Moreover, because it is a matter of purely internal operations, it is unlikely that the public will become aware of the issue and force a reconsideration of the policy without disclosure. On the other hand, the conduct at stake is not illegal. As long as the Board has deliberated with due diligence, it would presumably be within the parameters of business judgment and due care.

The comments to the Draft ALI Nonprofit Law principles recognize this conundrum and ultimately conclude: "no definitive approach to media contacts can be articulated. In making the decision to bring pressure on the charity through the media, the fiduciary should act in accordance with his or her duties to the charity, usually after conferring with independent counsel."²⁷ In my view, this opening to disclosure is too

²⁷ ALI Nonprofit Law Principles Draft No.4 s.350 comment d.(5) at 249.

large and thus threatens to eviscerate the usefulness of confidentiality from the governance perspective. If we assume the complained of conduct is wrongheaded and perhaps distasteful but not illegal (or even unethical), we must consider whether it is important enough to be sure that all pressures are brought to bear on the decision to be worth undermining the availability of information critical to the governance process. While it is often easy to see the benefits of disclosure in noteworthy cases where scandals are uncovered or policies are reversed, it is more difficult to see the costs of disclosure which may in part be measured in reluctance to discuss things with board members, lost opportunities and agenda setting by the disgruntled minority

C. What are the Alternatives to Disclosure? Resignation may be neither satisfactory nor desirable.

Before we propose a blanket rule of confidentiality or a series of exceptions, it is worth considering what alternatives a good faith dissenter has. The first option is to clearly express that dissent and the reasons therefor with the Board itself and request that such dissent be registered in the corporate minutes. Where the action or decision at stake falls within the parameters of the business judgment rule, this route seems appropriate. It reflects a respect for the governance process and the vote of the majority even if the majority may at times be wrong.²⁸

In cases, however, where the dissenter believes that the action or decision at stake violates a fiduciary responsibility, dissent alone may not be enough. In cases where the dissenter believes that the Board's governance process has been inadequate, perhaps because of a dominant personality or inadequate attention, it would seem appropriate for the dissenter to demand and be given a process for greater consideration of the issue including perhaps independent legal advice at the expense of the organization. While additional process and independent counsel may add material expense, at least in the abstract, that expense seems a justifiable price to pay to maintain confidentiality. The additional process or presence of independent counsel may also be sufficient to cause the Board to act responsibly in cases where it has not or to convince the dissenter that the action reflects a valid difference of opinion rather than negligence.

A difficult situation arises where the dissenter believes that the Board's action (or inaction) may be taken in good faith but is so significant as to threaten the integrity or long term viability of the organization or where attempts to obtain independent advice or adequate process have been rebuffed. In such cases, it is common to expect Board members to resign. Resignation, however, may be neither satisfactory nor desirable. Obviously, resignation generally will not change the outcome of the decision or process. It will not ensure that the action is within the parameters of the business judgment rule. More importantly, in an era that recognizes inattentive or excessively compliant Boards

²⁸ It would be fully consistent with this approach to continue to campaign internally for Board reconsideration of the issue. Of course, at a certain point, if Board members believe they have adequately considered and rejected reconsideration, a continued campaign may obstruct other business and may in some cases cause other directors to vote against reelection.

as a major governance issue, it is important to have constructive dissent in the Board room.

It is interesting to note that in this context, the situation may be somewhat different in the not-for-profit world than for a publicly held business corporation. Item 5.02 of Securities and Exchange Commission Form 8-K requires publicly held corporations to disclose the resignation of any director or officer who resigns over a “disagreement with the company, known to an executive officer of the company, on any matter relating to the company’s operations, policies or practices” along with a description of the disagreement and any written correspondence provided by the resigning director relating to the “circumstances surrounding his or her resignation.” Form 8-K information becomes publicly available on filing. Indeed, the recent Hewlett Packard controversy over the corporation’s use of “pretexting” to obtain 3rd party phone records came to light publicly as a result of this filing requirement (see attached Form 8-K filed by Hewlett Packard on September 6, 2006).²⁹ Perhaps similar disclosure should be required on the IRS Form 990.

D. Analogy to Attorney-Client Privilege.

Sarbanes-Oxley and its regulatory aftermath have focused significant attention on the limits of confidentiality in the analogous context of the attorney-client relationship. Generally, the attorney-client privilege prevents a lawyer from disclosing confidential communications made to the lawyer by the client for the purpose of enabling the client to obtain legal advice. The purpose, of course, is to enable candid communication and to encourage clients to seek legal advice. This underlying purpose is similar to the purposes of Board room confidentiality.

In the wake of Enron and similar corporate scandals, the Securities and Exchange Commission proposed the so-called “up-the-ladder reporting” and “noisy withdrawal” rules, and the American Bar Association revised its Model Rules of Professional Conduct relating to the attorney-client privilege. The final “up-the-ladder reporting”³⁰ and ABA rules³¹ are roughly similar. In each case, the rules permit an attorney to disclose confidential information to outside parties where 1) the conduct constitutes a violation of law, 2) disclosure is necessary to prevent or rectify substantial injury, and 3) the issue has been presented to senior management and the Board without adequate response.

²⁹ “In late July, [resigning director] Perkins ... pressed the company to make a more thorough disclosure to the SEC of the circumstances of his resignation. On August 14, after these requests were ignored, Perkins got serious. In a letter written on Kleiner Perkins letterhead, Perkins put the HP board, Sonsini, and Baskins on notice that he considered the May 22 8-K that announced his resignation to be defective. ‘I resigned solely to protest the questionable ethics and the dubious legality of the chairman’s methods [in the leaks investigation],’ he wrote. Because the company had refused to disclose this, he warned, he was legally obligated to go public.” Susan Beck, *The Trouble with Larry*, *The American Lawyer*, Dec. 1, 2006. When the Company refused to amend the Form 8-K, Perkins counsel notified regulators of the situation. *Id.*

³⁰ 17 C.F.R. 205.3(d)(2).

³¹ ABA Model Rules of Professional Conduct 1.13 and 1.6 (2003).

E. Relationship to Standing to Sue.

In considering limits that one might place on a duty of confidentiality, it is perhaps worth considering the relationship of this issue to the issue of standing to sue a not-for-profit corporation. The public (even in their capacity of beneficiaries of the not-for-profit corporation) generally does not have standing to sue without Attorney General consent.³² Similarly, donors generally have no standing to sue.³³ In most states, only the trustees themselves³⁴ and the Attorney General (or other relevant regulator) are given the authority and responsibility to protect the public's interest by being given standing to sue. In contrast, in the corporate context, each shareholder has standing to sue the corporation.

The reasoning behind this limited access to the courts in the nonprofit sector is that the public is not considered to have a sufficient stake in the organization to merit standing, and the risk of unmeritorious litigation is considered too costly and distracting to be permitted. Applying similar reasoning to access to confidential information, a strong argument could be made that limitations on the duty of confidentiality should run only to the benefit of the attorney general (or other relevant regulators) who is trusted to act on behalf of the public interest if action is merited.

F. Distinctions Based on Content.

1. Subject Matter.

(a) Conscientious Dissent vs. Utilitarian Disclosure of Confidential Information. Not only is it often difficult to distinguish conscientious dissent from political manipulation, the examples above clearly demonstrate the damage that can be caused even by conscientious dissent. A rule that generally required confidentiality but left it to the judgment and conscience of each Board member to determine when an issue merited public airing, would leave insufficient confidence for management and would rest authority in the individual director rather than the Board as a whole. It is perhaps fair to say, however, that where a Board member has not dissented from action of the Board (contemporaneously or subsequently), disclosure of related nonpublic information will not be appropriate.

(b) Operations and Governance vs. Policy or Advocacy (internal vs. external). In the context of the ACLU dispute, at least one commentator recommended a “two-tier

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³³ Herzog Foundation v. University of Bridgeport, 699 A.2d 995 (1997). But see, Smithers v. St. Lukes-Roosevelt Hospital, 281 A.2d 127 (Sup. Ct. App. Div. 2001).

³⁴ Holt v. College of Osteopathic Physicians and Surgeons 61 Cal 2d. 750 (1964) (Minority of trustees has standing).

approach” to confidentiality. With this approach, “The first tier would focus on the duties of directors who dissent from “everyday” board decisions involving governance and operational issues. The second tier would focus on policy decisions relating to advocacy choices.”³⁵ The first tier would have a higher interest in confidentiality on the theory that once a decision is properly reached on matters of internal operations, the public has no substantial interest in the result. Perhaps there is also an assumption embedded within this view that reasonable minds will often differ on matters of operations. The second tier would permit public discussion because of the importance of such issues to the substance of the organization and its public beneficiaries. Indeed, the ACLU report itself drew a similar distinction.³⁶

As we saw in example 9, however, operational issues may also involve important policy issues. Operations issues may also be fundamental to the stability and integrity of the organization and thus arguably of equally great import to the public (e.g. the expansion of service issue in example 3, the leadership issue in example 7, the ethical guidelines issue in example 8). Moreover, legal compliance issues and duty of loyalty issues which present the most compelling case for disclosure in my view may be more likely to arise in the context of operations and governance issues.³⁷ It is worthwhile to note that the SEC rules requiring disclosure of resignations by directors covers both operations and policy issues.

(c) Business Judgment or Negligent conduct. Another possible distinction would be to permit disclosure of nonpublic information where Board action (or inaction) could not be found to be reasonable within the meaning of the business judgment rule. That is when the dissenting board member believes that the Board’s conduct is so outrageous it violates the duty of care or so fundamental that it violates the duty of obedience. Such a determination will often be difficult for the dissenter to make with objectivity. Nonetheless, its effort to narrow the scope of disclosure to recognize the latitude given to a Board majority to act on behalf of the organization and its beneficiaries is helpful, particularly if a disinterested party is available to evaluate the distinction rather than the dissenter or the media.

(d) Violations of Law.

Narrowing disclosure to alleged violations of law as in the context of attorney client privilege would provide greater objectivity to the decision of the dissenter (and thus give

³⁵ Jack Siegel, Charity Governance Blog at http://charitygovernance.blogs.com/charity_governance/2006/05/stifle_yourself.html.

³⁶ The operations vs. policy advocacy distinction points to another distinction discussed earlier in this paper. That is, the distinction between disclosure of nonpublic information and the disclosure of disagreement with corporate decisions. The latter is a broader category of disclosure. Operations decisions may be more likely to rely on nonpublic information, whereas advocacy policy decision may be easy to debate without reference to anything other than the fact of the Board decision.

³⁷ The proposed ACLU guidelines recognized that disclosure might still be appropriate in the context of operations issues where allegations of illegal conduct were involved. ACLU report, *supra* note ____.

comfort to Board leadership) while respecting the role of the whistleblower. It may, however, be too narrow.

2. Different Types of Organizations. It also has been suggested that the type of not-for-profit corporation involved may affect the appropriateness of a duty of confidentiality. In particular it has been suggested that limitations on the speech of Board members is less appropriate for advocacy organizations than for service organizations. This distinction is an extension of the “operations” vs. “policy” distinction discussed above. It is possible that confidential issues will arise less frequently in the governance of an advocacy organization, but the principles illustrated in the examples above are nonetheless applicable. Of course, if there is a duty of confidentiality, organizations could certainly choose to waive it if they found its application inappropriate to the organization’s mission.

3. Timing of Disclosure. As illustrated in examples 3, 4 and 9 above, the timing of disclosure of confidential information also may make a significant difference. Oddly, disclosure which results in criticism of actions that have reached a final determination seems much less destructive than premature disclosure which may jeopardize an opportunity and uses the force of the media to override the vote of the Board majority. Public disclosure prior to completion of all relevant internal governance procedures also seems particularly inappropriate.³⁸

G. Different types of Board members.

(1) Ex Officio Board Members and Affiliate Representatives. Ex officio Board members are board members who hold their seats by virtue of the office they hold. A common example is a government official whose office includes a seat on the Board of an organization to which the government provides significant funding – a deputy mayor who has a seat on the board of the local library or a commissioner of cultural affairs that has a seat on the board of a museum. In such cases, the board member is a representative of another entity. Such an arrangement may be desirable for the entity that is represented because it allows it to monitor more closely the use of its funds. It may be desirable for the nonprofit because it provides a mechanism for early and regular communication with a significant constituency to ensure that it is aware if that constituency will disagree with any proposed course of action. In this context, the whole purpose of the structure is to provide communication. Accordingly, it would be destructive to expect the ex officio board member not to disclose information to the entity he represents. The same could be said of a national organization whose Board includes representatives of local affiliates. In these type cases, it seems appropriate to permit the Board member to disclose Board information to the group it represents as long as

³⁸ For example, disclosure of the ACLU Board’s consideration of nondisclosure guidelines before a final draft was presented for approval to the Board seems like a glaring example of politics and manipulation rather than the act of a frustrated whistleblower.

measures are taken to ensure that the information is not further disclosed beyond that entity without the consent of the corporation.

(2) Honorary Board Members. Many not-for-profits have honorary trustees. These are generally highly visible individuals who lend their names in support of the organization but have little or no involvement in the organization’s day-to-day affairs or governance and no right to vote at board meetings. Their participation is “honorary”. Courts have held that honorary board members have no fiduciary relationship to the organization.³⁹ As a result, it is difficult to expect them to owe a duty of confidentiality. As long as not-for-profit corporations are aware that they cannot expect confidentiality from honorary directors, steps may be taken to ensure that they present little threat to open governance.⁴⁰

H. Should Confidentiality be a Matter of Law or Organizational Policy?

An argument can be made that any duty of confidentiality should arise solely by Board adoption of a confidentiality policy rather than by law. This approach would allow each organization to consider the level of confidentiality appropriate for its particular circumstances and mission. While such an approach may be tempting for larger more sophisticated organizations, it is insufficient for the myriad of smaller organizations. Given the important interests served by confidentiality in the governance process, it is preferable to recognize a general duty of confidentiality imposed by law and permit organizations to waive it in their by-laws, codes of ethics or similar policy documents.

IV. CONCLUSION.

The corporate scandals in both the business and nonprofit sectors have shown us (1) that Boards need more information and candid deliberation and (2) that in the absence of outside pressure, Boards do not always come to the right conclusions even in

³⁹ Steeneck v. University of Bridgeport, 235 Conn. 572 (1995).

⁴⁰ Where an organization has honorary directors, it may be prudent to clarify in the organization’s by-laws, that honorary directors are not generally invited to attend board or committee meetings although they may attend by special invitation. In that case, board meeting materials should not be distributed to honorary directors.

Emeritus Board members are slightly different than honorary board members. Although emeritus board members are also generally nonvoting, their status generally is based on their high level of historic involvement with the organization and their deep understanding of the organization. The organization benefits from their emeritus status by continuing to have the benefits of their engagement at a time when they would otherwise retire. This engagement may include both continuing to share the benefits of their past experience in the board room and continued contributions. Because emeritus trustees may add to the governance process, it seems worthwhile to permit them to attend meetings and receive confidential information. Therefore, even though emeritus trustees do not vote, it seems essential to require the same confidentiality from them as from voting board members.

egregious cases. Part of the solution to the first issue is to create processes and mechanisms to encourage the flow of candid information to the Board. A presumption of confidentiality is very important to that effort. Unfortunately, a reliable presumption of confidentiality cuts against the ability to engage outside pressure to remedy the second issue.

Our governance system is based on the premises that oversight responsibility rests with the Board of Directors of a nonprofit, that Boards act only as a group, and that the decisions of Boards will not generally be second guessed if they are the product of due deliberations. Putting all of these premises together, in my view, points to both a need for, and an acceptance of, the strictures of Board confidentiality. There must be an implied agreement that in exchange for the right to receive information that they would not otherwise have, Board members are expected to keep that information confidential.⁴¹

In deciding the bounds of this confidentiality we must remember that frequently disgruntled directors are correct. We also must remember that frequently dissenting directors are wrong. As a result, the evaluation of the need for disclosure to the public should not be left to the dissenter alone. Accordingly I believe it is appropriate to recognize an absolute duty of confidentiality with respect to nonpublic corporate information by Board members with respect to the media and the general public as long as we recognize that this duty does not prevent disclosure of such information to the Attorney General or other regulators (after notifying the Board of the disagreement and attempting to resolve the issue internally). This leaves it to the regulator to attempt to judge whether the issue at stake is actionable or whether it is within the domain of the Board's exercise of its responsibilities. It also removes the ability to conduct Board meetings in the media.

It is important to emphasize that this approach places a huge and difficult responsibility in the hands of the regulator. The regulator must recognize that despite the fervor and sincerity of a dissenting Board member, most Board disagreements will be simply that --Board disagreements -- and will not require intervention. It also requires regulators to understand that their involvement and resulting investigation may result in significant expense and resource drain to a nonprofit. As a result, regulators must tailor the extent of their engagement to the extent and credibility of the problem.

Finally I would note that although we have seen several examples of prominent board room leaks in the last few years, I would hypothesize that most executives and board members assume there is some obligation to maintain board room confidentiality. Indeed many, and perhaps most, Board handbooks and codes of ethics refer to an

⁴¹ Damages for the breach of confidentiality will be difficult to ascertain. Depending on the circumstances of the breach, however, the continued presence of the breaching Board member on the Board may have a significant chilling affect on board governance and deliberations. Accordingly, breach of the duty of confidentiality should be deemed reasonable grounds for removal of the director by vote of the remaining directors.

expectation of confidentiality from Board members although the source of that expectation may be unclear.