



COLORADO GOVERNANCE PRINCIPLES

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I. INTRODUCTION

Following revelations about the Enron and WorldCom scandals in 2001 and 2002, respectively, 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 (“Sarbanes–Oxley”). Because social sector organizations also had their share of scandals involving conflicts of interest, self-dealing by insiders, excessive compensation, and similar issues, several states 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 thereafter. Following the recent economic downturn, Congress enacted the Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd–Frank”), which President Obama signed into law in July 2010. Although good governance was not the primary goal of Dodd–Frank, certain provisions in Dodd–Frank are influencing, or will influence, corporate and nonprofit governance.

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 generally accepted auditing practices. In the discussion below, we outline several of the good governance principles embodied in federal securities and Colorado state laws applicable to social sector organizations.

II. THE SARBANES–OXLEY GOOD GOVERNANCE PRINCIPLES

Except for provisions concerning document destruction and whistleblower protection, the governance provisions required by Sarbanes–Oxley apply only to public companies, not to social sector organizations. Nevertheless, the reforms prescribed by Sarbanes–Oxley have become a touchstone for the governance principles and practices of many organizations. 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, and other constituents.

In 2005, the American Bar Association (“ABA”) Coordinating Committee on Nonprofit Governance published the “Guide to Nonprofit Corporate Governance in the Wake of Sarbanes–Oxley,” in which it provided ten general principles “worthy of consideration for the governance of nonprofit organizations.” Those principles, which may or may not be appropriate for a particular organization, are as follows:

A. Role of the Board

The organization’s governing board should oversee the operations of the organization in such manner as will promote 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 (i) seeks to assure the independence of the organization’s financial auditors; (ii) reviews the organization’s critical accounting policies and decisions and the adequacy of its internal control systems; and (iii) 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 which 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. Chief executive officers ("CEOs") and chief financial officers 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, and to some extent overlap, with the IRS Form 990 policy and procedure disclosures described below.

III. DODD–FRANK GOOD GOVERNANCE PRINCIPLES

Although many of the key provisions of Dodd–Frank apply specifically to financial services firms and their related activity, Dodd–Frank includes the following key provisions on corporate governance that could have an indirect effect on nonprofit governance:

A. Say-on-Pay

Shareholders of public companies must have periodic nonbinding advisory votes on executive compensation. Because many nonprofit organizations lack voting members, the application of say-on-pay in the nonprofit context might be limited.

B. Additional Disclosures With Respect to Executive Compensation

A public company’s annual proxy statement must contain a clear presentation of the relationship between executive compensation and the company’s performance, including disclosure of the median annual total compensation of all company employees (excluding the CEO), the CEO’s annual total compensation, and the ratio of the two amounts. These additional executive compensation disclosures could have applications to the nonprofit context because many nonprofit corporations already prepare and file financial reports, including compensation policies, pursuant to IRS requirements.¹

C. Expanded Clawback

Dodd–Frank expands the Sarbanes–Oxley rules regarding clawbacks of executive compensation. Public companies are required to adopt and disclose policies for clawing back incentive-based compensation paid to current or former executive officers in the event of a restatement of the company’s financials due to material non-compliance with any federal securities law’s financial reporting requirement. The requisite policy must provide for clawing back excess compensation any such executive officer received during the three-year period prior to the date on which the company was obliged to issue the restatement. Excess compensation is the difference between what the executive was paid and what the executive would have received if the financials had been correct. Public companies failing to adopt such policies will be delisted.

In the nonprofit context, executives generally have less complicated compensation programs than do executives in for-profit public companies. Although nonprofit executives do not receive stock-based compensation, they may receive other incentive-based compensation (e.g., a cash bonus tied to financial performance) that could be put similarly at risk by a clawback provision should circumstances be appropriate for such an arrangement.

¹ See *infra* Part IV.B.6.

D. Single Chief Executive Officer–Chairman

Dodd–Frank requires that public companies disclose whether the same person holds both the CEO and chairman-of-the-board positions. Dodd–Frank further requires that companies disclose their reasons for having or not having the same person hold both positions. In light of Dodd–Frank, nonprofit organizations may consider reviewing more closely the potential division of CEO–chairman roles that are currently unified.

E. Enhanced Whistleblower Protections

Dodd–Frank includes incentives and protections for whistleblowers that are broader in scope and depth than those that were created under Sarbanes–Oxley. Dodd–Frank whistleblower provisions include, among other items, a bounty incentive for tips resulting in securities-law enforcement actions and an extension of the statute of limitations for whistleblowers to invoke statutory protections.

Enhanced whistleblower protections could have numerous applications in the nonprofit context. First, grant organizations could condition contributions on nonprofit recipients’ implementation of whistleblower policies. Second, good governance groups (e.g., ABA Coordinating Committee on Nonprofit Governance) could seek to expand whistleblower protections through best practices and other informal guidance.² Third, the IRS currently encourages nonprofit organizations to have effective whistleblower policies in place.³

F. Compensation-Committee Independence

Dodd–Frank made independence even more visible within good governance principles when the SEC adopted new rules to address independence standards. Under these rules, companies that are traded on United States public exchanges must evaluate whether compensation committee members are independent. As part of this analysis, companies must consider (a) the director’s source of compensation and (b) whether the director is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

Other factors that are to be considered as part of making an independence determination include whether:

1. The director is a current or former employee of the company or has an immediate family member who has been an executive officer of the company.
2. The director or an immediate family member has received significant direct compensation or contracts from the listed company.

² See *supra* Part II.

³ See *infra* Part IV.B.2.

3. The director is a current partner or employee of the listed company's auditor or has an immediate family member who is so employed.
4. The director or an immediate family member is or has been an executive officer of another company where the company's present executive officers served on that company's compensation committee.
5. The director is a current employee, or an immediate family member is a current executive officer, of a company that has done significant corporate business with the company.

Such committees can be useful to non-profits in numerous ways. Because they are able to focus solely on compensation matters and devote their full attention to solving any related difficulties within the organization, compensation committees can seek to ensure that the organization is reasonably paying its staff and board for their services and help the organization comply with Internal Revenue Service (“IRS”) requirements and protect its tax-exempt status.⁴

Many nonprofit organizations may consider adopting similar governance policies, especially those organizations that already have a largely independent board of directors or advisors. The IRS is already encouraging compensation committee independence by requiring nonprofits to disclose (1) the number of independent directors and (2) the process by which compensation of top management officials is determined. Further, independent board and committee members both can demonstrate organizational integrity, which could inspire public confidence, and decrease the likelihood that oversight failure may occur.

G. Compensation Committee Adviser Independence

Dodd-Frank also provides that a company’s compensation committee can select a consultant, legal counsel (excluding in-house counsel) or other adviser only after it considers the following six independence factors:

1. services provided by the adviser’s employer to the listed company;
2. fees the adviser’s employer has received from the listed company, as a percentage of that person’s total revenue;
3. conflict-of-interest policies and procedures that the adviser’s employer has adopted;
4. any business or personal relationship the adviser has with a member of the compensation committee;
5. any stock of the listed company that the adviser owns; and

⁴ For more information on whether or not a compensation committee might be useful for a particular organization, see Eileen M. Morgan, Whiteford, Taylor, and Preston LLP, *Compensation Committees: Does Your Organization Need a Compensation Committee?* (2006), available at http://www.wtplaw.com/sites/default/files/document_pdf/article/compensation_committees_does_your_organization_need_a_compen_2.pdf.

6. any business or personal relationship with an executive officer of the issuer that the adviser might have.

Compensation committees of nonprofits might look to these types of relationships between nonprofits and potential service providers to the compensation committee when considering the independence of such service providers.

IV. GOVERNANCE POLICIES ENCOURAGED BY THE IRS

The IRS is encouraging improved nonprofit governance in three ways. First, the IRS has adopted a checklist to help its examiners determine whether governance practices affect an organization's tax compliance. Second, the IRS has trained its employees as to how nonprofit governance affects determinations and rulings. Third, the IRS has engaged in subtle regulation of nonprofit corporate governance through new disclosure requirements in its Form 990—Return of Organization Exempt from Income Tax.

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 2009 tax filings, the IRS substantially revised Form 990 by incorporating a series of yes-or-no questions relating to some of the nonprofit corporation's governance principles and practices. Although the Form 990 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, and employees. The IRS may also use responses to evaluate which tax returns warrant more careful review or possible audit. Therefore, the revised Form 990 provides an incentive for nonprofit organizations to adopt many of these principles and practices not otherwise required by law.⁵

A. Independent Directors

Form 990 requires a nonprofit corporation to disclose the number of "independent" directors, as defined in the Form 990 instructions. Under the instructions, a director is considered independent if all three of the following circumstances applied at all times during the nonprofit corporation's fiscal 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

⁵ More information and resources regarding the IRS and corporate governance are available at http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

- Neither the director nor any family member was involved in a transaction with the nonprofit corporation or a related entity that was required to be reported under Schedule L of the Form 990.

This Form 990 disclosure focuses on compensation received by directors or their relatives from the nonprofit organization or an affiliate. A comparison of the number of independent directors to the total number of directors also could color the view of the IRS and the public as to the adequacy of the nonprofit organization's governance practices.

Another related question in the Form 990 requires the organization to identify any officer, director, or key employee who has a family relationship or business relationship with another officer, director, or key employee. The instructions indicate 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 a minimum, the disclosure of the names of the parties and a general description of the relationship.

B. Policies and Procedures

Form 990 asks whether the nonprofit corporation has adopted certain policies and procedures related to corporate governance. Although these policies are not required by law, an inference could be drawn that a well-run nonprofit corporation would adopt them. Some of the more significant policies and procedures include:

1. Conflict-of-Interest Policy

For several years, the IRS has strongly encouraged the adoption of a conflict-of-interest policy for nonprofit organizations under I.R.C. § 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. They must further disclose whether officers, directors, trustees, and key employees are required to provide frequent updates on interests that could give rise to these types of conflicts, such as through a list of family members, substantial business or investment holdings, and transactions or other affiliations with potentially conflicting parties. The IRS also requires nonprofit organizations to disclose any conflict-of-interest policies in Form 1023—Application for Recognition of Exemption. Form 1023 notes that a conflict-of-interest policy is recommended, though not required, to obtain tax-exemption status.

2. Whistleblower Policy

Form 990 seeks to ensure that nonprofit corporations have effective whistleblower policies in place. An effective whistleblower policy will establish a process for confidential reporting of

potential wrongdoing so that the organization can investigate and, if necessary, correct any problems, while eliminating the chance of retaliation against the whistleblower.

3. Record-Retention and Document-Destruction Policies

In accordance with Sarbanes–Oxley, Form 990 asks if the nonprofit corporation has a written policy covering not only document retention and destruction, but also standards for document integrity, such as guidelines for handling electronic files, backing up files, archiving documents, and testing periodically the reliability of the document maintenance system.

4. Compensation Policy

Form 990 asks if the nonprofit corporation has a policy in place for determining whether the compensation of its top management officials is reasonable. Such a compensation policy will likely include (a) review and approval by a compensation committee within the organization that is free from conflicts of interest; (b) use of data regarding comparable compensation of similarly qualified persons in functionally comparable positions; and (c) contemporaneous documentation and record keeping of deliberations and decisions about compensation arrangements.

5. Joint-Venture Policy

If a nonprofit corporation engages in joint ventures or similar arrangements, such as partnerships, whether with nonprofit or for-profit partners, the nonprofit organization 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.

6. Form 990 and Governance-Disclosure Policies

Form 990 requires a nonprofit corporation to disclose its methods for making the Form and any other governance documents available to the public. The disclosure includes a narrative description as well as the name and address of the person possessing the books and records of the corporation.

7. Chapter-Relations Policies

Form 990 asks whether a multi-level nonprofit organization has policies and procedures to ensure mission consistency throughout the organization, including in other chapters, affiliates, and branches. Many nonprofit corporations engage a lawyer to review the Form 990 before submission due, in part, to the increased complexity and legal implications of these new disclosures.

C. Open Data Policy

Pursuant to a May 9, 2013 Executive Order advocating greater governmental transparency,⁶ the IRS (and all other agencies and departments) will have to make public information available in a machine-readable format. This change could also affect organizations filing a Form 990, as the filings will be more readily available and more easily subject to computerized analysis. The possible greater level of scrutiny might further encourage organizations to be sensitive about the answers provided. Greater scrutiny, a wider audience, and ease of access could have implications for donor, IRS, and employee relations alike.

V. GOVERNANCE UNDER COLORADO LAW

In 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 the duties of care and loyalty.

1. Duty of Care

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 directors act honestly, with faithfulness to their duties and obligations, and not attempt to take advantage of the organization. “Care of an ordinary prudent person . . . in similar circumstances” requires that directors act in accordance with their specific role within the organization. Finally, directors must *subjectively* believe that their acts are “in the best interests of the nonprofit organization,” and those beliefs must 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, including its activities, goals, size, complexity, and financial status;

⁶ Under the Open Data Policy, agencies and departments must collect and create information in a way that supports downstream processing and sharing, though the use of machine-readable and open formats, data standards, and common core and extensible metadata. The plan will be fully implemented by November 2013 and require quarterly agency reporting at that time. More information available at <http://www.whitehouse.gov/sites/default/files/omb/memoranda/2013/m-13-13.pdf>.

- Confirming that the nonprofit organization has submitted all required filings;
- Making informed decisions, by conducting a thorough review of all materials submitted to the board of directors; and
- Attending and actively participating in all board meetings, events, and substantial decisions made within the organization.

2. Duty of Loyalty

The duty of loyalty requires directors to act in the best interest of the nonprofit corporation and to avoid conflicts of interest. This duty includes a prohibition against usurping opportunities from the organization. Thus, directors must not engage in enterprises directly in competition with or having an injurious or detrimental effect on the organization. Directors must also 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 addresses conflicts of interest by regulating conflicting-interest financial transactions. A conflicting-interest transaction involves a contract, transaction, or other financial relationship between (1) a nonprofit corporation and (2) a director, a party related to the director, or an entity in which the director is an officer or director or has a financial interest. Although nonprofit organizations should generally avoid conflicting-interest transactions, the Act allows 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 “fair” to the nonprofit organization. Fairness is determined by evaluating whether full disclosure is provided regarding the details of the transaction, whether the amounts paid or charged are reasonable, and whether the transaction is in the best interest of the nonprofit organization.

Notwithstanding these allowances, Colorado law prohibits nonprofit corporations from making a loan 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 such loan.

B. The Board of Directors

Colorado law provides specific requirements for a nonprofit corporation’s board of directors in connection with its size, terms, composition, and conduct. Unless otherwise provided in the nonprofit corporation’s articles of incorporation, the Act requires that a nonprofit corporation have a board of directors comprised of at least one director, and the number of directors must be

stated in the organization's bylaws. Each director must be an "individual"; therefore, a corporate entity may not serve on a board. Unless otherwise provided for in the bylaws, a Colorado nonprofit corporation must have a president, secretary, and treasurer, with each position filled by someone at least eighteen years of age, but not necessarily by a separate individual in a split role. Absent a provision in the bylaws fixing the terms of office, a director's term of office is one year. Finally, although some nonprofit organizations discourage compensation of 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 to provide oversight over management of the nonprofit corporation's business and affairs. Typical board duties 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 be knowledgeable about, and comply with, all applicable federal, state, and local laws and regulations. Apart from the Sarbanes-Oxley provisions covering whistleblowers and document destruction, Colorado law requires that nonprofit corporations keep minutes of all board meetings, along with a record of any actions taken by the board without a meeting, as part of their permanent records. Whether acting as an individual or as a member of a board, a director is 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. In certain circumstances, however, the corporate form does not provide protection from liability.

As noted above, directors and officers have 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. Assent to or participation in an improper conflicting-interest transaction might also result in director liability to the corporation. A director could breach his or her duty of good faith through deliberate neglect of duties or failure to provide adequate disclosure to the organization's other directors or members when seeking their approval for a transaction. Depending on the circumstances, a director's failure to make informed decisions, consistently attend board meetings, or complete required filings could result in 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 rectified 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. A director remains subject to other obligations under the law, such as compliance with certain Colorado wage-claim statutes.

Colorado law provides for the mitigation or elimination of director liability in certain circumstances. As do 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. Under the business judgment rule, a director may avoid liability by proving that his or her decision was merely "rational," as opposed to "reasonable." To fully incorporate the business judgment rule, a nonprofit corporation must include express provisions in its articles of incorporation requiring that a director's decision be merely rational to avoid liability. Colorado law provides directors and officers some relief from liability if decisions are reasonably based on information provided by other reliable parties. 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 or committed a criminal offense in connection with the matter.

Furthermore, the use of volunteers, including volunteer directors, may pose a risk of liability for a nonprofit corporation. Apart from the federal Volunteer Protection Act's ("VPA") limitations on volunteer liability, Colorado has adopted statutory provisions protecting volunteers from liability if their action was within the scope of their volunteer duties, was not willful or wanton, and did not cause harm to a third party. Neither the VPA nor Colorado law shields the nonprofit corporation from vicarious liability arising from the actions of its volunteers. However, Colorado and federal law provide immunity from liability to directors and officers of nonprofit corporations who are volunteers under certain circumstances.

Other mechanisms for reducing or eliminating liability include indemnifications, insurance, and liability waivers. First, the Act allows a nonprofit organization, in its articles of incorporation, to indemnify a director, officer, fiduciary, or agent from most civil liability arising out of that person's service on behalf of the nonprofit organization. Second, under Colorado law, a nonprofit organization may purchase and maintain insurance covering liability asserted against or incurred by directors or officers. Third, a nonprofit organization may reduce risk exposure by requiring volunteers and, to the extent applicable, the recipients of its services, to sign a waiver or release of claims.

VI. RESOURCES

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