

January 18, 2008

Evan Richert
University of Southern Maine
Suite 308
6 State Street
Bangor, ME 04401

RE: NERACOOS Legal Questions (MASGP 08-007-01)

This product was prepared by the National Sea Grant Law Center under award number NA06OAR4170078 from the National Oceanic and Atmospheric Administration, U.S. Department of Commerce. The statements, findings, conclusions, and recommendations are those of the authors and do not necessarily reflect the views of NOAA or the U.S. Department of Commerce.

Dear Evan,

Thank you again for contacting the Law Center on behalf of NERACOOS. This letter contains our responses to the legal questions you raised in your January 4, 2008 email. The following information is intended as advisory research only and does not constitute legal representation of NERACOOS by the National Sea Grant Law Center. It represents our interpretation of the relevant law.

The Regional Associations (RAs) tasked with developing and maintaining an integrated coastal and ocean observing system for the U.S. have a monumental job on their plates. One of the most challenging aspects of IOOS has been governance - how should the RAs be structured to carry out their mission. Since becoming involved with IOOS in 2004 when first contacted by Ocean.US, the Law Center has produced a number of memorandum of law to help individuals involved in this effort address the emerging legal issues. Two of the most relevant memos are attached. One discusses the issue of federal participation on the boards of RAs and the other tort liability for data and products. Your remaining questions are addressed below in the order posed in your email.

Can Board Members who represent foreign entities participate in making decisions about how U.S. federal funds are spent?

The best way to determine whether foreign entities may participate in these decisions would be to consult the federal agency issuing the funds. If the agency does not allow board members representing foreign entities to participate in these types of decisions, the board member could always abstain from voting or participating in related board meetings.

What is the best state for incorporation?

One study of jurisdictional choice in incorporation of the nonprofit sector found that charitable organizations tend to incorporate in the state in which their activities are centered.¹ The authors found that no dominant state has emerged as the "best" state for incorporation (in contrast to Delaware as the dominant state of incorporation for the private sector).²

Can a nonprofit be incorporated in one state but have its office in another? Which laws would the nonprofit be subject to?

A corporation may incorporate in one state but have its office in another. However, if a nonprofit corporation incorporated in one state and had its principal place of business in another, the corporation would probably have to qualify to do business in the other state. Many states require "foreign" corporations, or corporations incorporated in another state, to obtain a certificate of authority from the Secretary of State to transact business in that state. Likewise, most states require nonprofits with an out-of-state charter to file for authorization within the state in which operations are located to operate as a foreign corporation qualified to do business in the state.³ This means that an organization may have to file twice, maintain two registered agents for service, file dual annual reports, and pay fees to both jurisdictions.⁴ Organizations may be concerned about incurring extra costs, particularly if problems arise in the future requiring the retention of out-of-state lawyers or meetings with out-of-state regulators.⁵

A nonprofit organization that incorporates out of state is usually required to comply with elements of law in both its home state as well as in the state of incorporation.⁶ A corporation incorporated in one state with its principle place of business in another state may be subject to the laws of either or both states, depending on the context.⁷ In the private sector, a corporation is often considered to be domiciled in its state of incorporation.⁸ For instance, a business incorporated in Delaware with a principal place of business in New York would probably be considered a Delaware corporation for choice-

¹ Jenkins, Garry W. "State-Level Legal Reform of the Law of Nonprofit Organizations: Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law" 41 Ga. L. Rev. 1113, 1116 (2007).

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.* at 1170-1171.

⁶ *Id.*

⁷ AM. JUR. CORPORATIONS § 257.

⁸ *Id.*

of-law purposes.⁹ However, there are exceptions. In one California case, the court held "Where a charity has been organized by California residents, is located in this state and has all of its assets and most of its activity here, we believe that actions taken in California concerning the administration of that charity should not escape the scrutiny of California law merely because the founders chose to incorporate elsewhere. Consequently, we hold that the law of California, to the extent it exists, is controlling."¹⁰

What are the implications of the Sarbanes-Oxley Act?

The American Competitiveness and Corporate Accountability Act, or the Sarbanes-Oxley Act, primarily affects only American publicly-traded corporations. However, two provisions also apply to nonprofit organizations - the "document retention provision" and the "whistleblower provision." Following the summaries below are recommendations from *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* published by BoardSource and Independent Sector.¹¹ In addition to the recommendations reprinted below, the publication also has helpful information on how nonprofits might apply non-mandatory provisions of the Sarbanes-Oxley Act to improve its management practices.

The Document Retention Provision

Section 802 of the Sarbanes-Oxley Act makes it a crime to knowingly alter, destroy, conceal or falsify any record or document with intent to impede, obstruct, or influence a federal investigation or the administration of any other federal matter. Violations of this provision are punishable by fines or imprisonment up to 20 years. Recommendations from BoardSource and Independent Sector:

A nonprofit organization should have a written, mandatory document retention and periodic destruction policy. Such a policy also helps limit accidental or innocent destruction.

The document retention policy should include guidelines for handling electronic files and voicemail. Electronic documents and voicemail messages have the same status as paper files in litigation-related cases. The policy should also cover back-up procedures, archiving of documents, and regular check-ups of the reliability of the system.

⁹ *Id.*

¹⁰ *Am. Ctr. for Educ., Inc. v. Cavnar*, 145 Cal. Rptr. 736 (Ct. App. 1978).

¹¹ Available at <http://www.independentsector.org/PDFs/sarbanesoxley.pdf> .

If an official investigation is underway or even suspected, nonprofit management must stop any document purging in order to avoid criminal obstruction charges.

The Whistle Blower Provision

Section 110 makes it a felony to retaliate against an individual for providing law enforcement authorities with truthful information relating to the commission, or possible commission, of any federal offense. Violations are punishable by fines or imprisonment up to ten years. For instance, if an employee reported a nonprofit's tax violation to the IRS, the nonprofit could not fire or otherwise punish the employee. Recommendations from BoardSource and Independent Sector:

Nonprofits must develop, adopt, and disclose a formal process to deal with complaints and prevent retaliation. Nonprofit leaders must take any employee and volunteer complaints seriously, investigate the situation, and fix any problems or justify why corrections are not necessary.

Additionally, the Act has spurred some state lawmakers around the country to propose and pass legislation extending similar accountability requirements to charitable and nonprofit corporations. Massachusetts and New York have proposed reforms. In 2005, California enacted the Nonprofit Integrity Act, which contains provisions borrowed from Sarbanes-Oxley, such as requirements for independent audits and audit committees.¹²

What are the implications of pending IOOS legislation in Congress with respect to the question of liability?

The National Integrated Coastal and Ocean Observation Act of 2007 (H.R. 2342), introduced on May 16, 2007, contains the following provision:

(6) CIVIL LIABILITY- For purposes of determining liability arising from the dissemination and use of observation data gathered pursuant to this section, any non-Federal asset or Regional Information Coordination Entity that is certified under paragraph (3)(D) and that is participating in the System shall be considered to be part of the National Oceanic and Atmospheric Administration. Any employee of such a non-Federal asset or Regional Information Coordination Entity, while operating within the scope of his or her employment in carrying out the purposes of this section, with respect to tort

¹² California Nonprofit Integrity Act of 2004, 2004 Cal. Stat. 919.

liability, is deemed to be an employee of the Federal Government.

Simply stated, if HR 2342 or a similar bill passes, RAs would be treated like federal agencies in the unlikely event they were sued as the result of the dissemination and use of observational data. The federal government and its entities enjoy sovereign immunity and may not be sued without their consent.

Congress through the Federal Tort Claims Act (FTCA) has waived immunity for tort claims based on negligence law. The FTCA "applies to claims (1) for money damages, (2) arising from damage to property, personal injury, or death, (3) caused by a negligent or wrongful act (4) of a federal government employee (5) acting within the scope of his or her employment, (6) in circumstances where a private person would be liable under state law."¹³ Despite this seemingly broad waiver of sovereign immunity, the FTCA contains two exceptions that make it unlikely that a federal agency would be held liable for damages incurred as a result of IOOS data, predictions, or products.¹⁴

Discretionary Function

The FTCA bars claims based on the acts of government employees carrying out statutory or regulatory obligations or performing discretionary functions.¹⁵ To be protected by the discretionary function exception, the government employee's act must involve an element of judgment or choice and the conduct must be based on consideration of public policy.¹⁶ The Supreme Court has stated that an element of judgment or choice is not present if a "federal statute, regulation, or policy specifically prescribes a course of action for an employee to follow."¹⁷ The underlying basis for this two-part test developed by the U.S. Supreme Court is that "Congress wished to prevent 'second-guessing' of legislative and administrative decisions grounded in social, economic, and political policy through the medium of an action in tort."¹⁸

¹³ Jonathan A. Willens, National Institute of Trial Advocacy, Commentary, Overview of Chapter 171: Tort Claims Procedure, LEXSTAT 28 US NITA PREC 2671 (2004).

¹⁴ It is important to remember, however, that even though most cases would be dismissed for lack of subject matter jurisdiction, very little can be done to stop an injured party from filing suit.

¹⁵ 28 U.S.C. 2680(a) (2005).

¹⁶ See *U.S. v. Gaubert*, 499 U.S. 315, 322-23 (1991).

¹⁷ *Berkovitz v. U.S.*, 486 U.S. 531, 536 (1988).

¹⁸ *U.S. v. S.A. Empresa de Viacao Aerea Rio Grandense (Varig Airlines)*, 467 U.S. 797, 814 (1984).

The federal government's and the RAs' decisions to participate in ocean observing and implement IOOS is clearly a discretionary function. There is currently no formal legislative or regulatory mandate that requires any federal agency or entity to develop and maintain a system. Even if Congress would pass legislation requiring the U.S. to maintain an integrated coastal and ocean observing system, the extent to which the government wishes to allocate resources and manpower to maintaining the required observing systems and making predictions from those observations should remain discretionary as well.

Misrepresentation

The FTCA also bars claims against the United States based on misrepresentation and deceit.¹⁹ The misrepresentation exception bars "claims arising from commercial decisions based on false or inadequate information provided by the government."²⁰ "Misrepresentation may result from the failure to provide information, as well as from providing information that is wrong."²¹ This exception is extremely broad and should result in the dismissal of almost all claims against the government based on inadequate or false IOOS data or products. Some courts, however, have rejected the application of the misrepresentation exception and impose liability when the injury was the result of a government employee's negligent performance of operational tasks, such as a negligent transmittal of data, as opposed to an individual's reliance of inaccurate government data. This case law should not be a cause of worry unless individuals responsible for collecting, transmitting, and analyzing IOOS data fail to follow protocols or use due care.

There is no compelling reason for an RA to postpone incorporation until federal legislation is passed granting RAs' federal status for liability purposes. First, similar legislation introduced in previous Congresses went nowhere and RAs could be waiting for something that will never happen. Second, the probability of a lawsuit is extremely low. And finally, while private entities have no immunity from suit, states, like the federal government, do enjoy sovereign immunity; they cannot be sued without their consent.²²

Like the federal government, some states have enacted tort claims acts allowing the state government to be sued in limited circumstances. For example, in Maine the state can be sued for

¹⁹ 28 U.S.C. 2680(h) (2005).

²⁰ *Frigard v. U.S.*, 862 F.2d 201, 202 (9th Cir. 1988).

²¹ *Ingham v. Eastern Air Lines, Inc.*, 373 F.2d 227, 239 (2nd Cir. 1967).

²² In addition, Congress has a limited power to waive the states' sovereign immunity from suit in federal court. See, e.g., *College Sav. Bank v. Fla. Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666 (1999).

negligence under the Maine Tort Claims Act. The "state" is defined as "the State of Maine or any office, department, agency, authority, commission, board, institution, hospital or other instrumentality of the State."²³ State universities and academic institutions would fall within this definition. A state government entity, however, is not liable for any claim that which results from:

Performing or failing to perform a discretionary function or duty, whether or not the discretion is abused and whether or not any statute, charter, ordinance, order, resolution or policy under which the discretionary function or duty is performed is valid or invalid.²⁴

In conclusion, in the event of a lawsuit it is highly probable that the federal and state entities contributing data and resources to an RA will be immune from suit under the "discretionary function" exceptions to the federal and state tort claims act. Private entities, unfortunately, do not enjoy such immunity. Insurance could be purchased to provide private participants with a safety net, but given the low probability of litigation, the cost could be prohibitive.

Conflicts of Interest

Selecting appropriate individuals to serve on the board of directors for NERACOOS is particularly challenging given the small community of individuals and organizations involved in ocean and coastal observing. There is a strong possibility that directors may, individually or through their employers, wish to compete for funds being distributed by the RAs. A situation could also arise in which a director is in direct competition with the RA, e.g. the RA and director submit grant proposals to the same institution.

Nonprofit organizations are generally held to a high standard when it comes to conflicts of interest. "The mere suspicion that someone involved with a nonprofit might be deriving personal gain from the relationship can be detrimental to the organization."²⁵ A nonprofit director has two primary obligations to the organization - the duty of care and the duty of loyalty. The duty of care is quite straightforward. Directors are required to take adequate steps to inform themselves when making decisions, including attending board meetings and reading minutes, and to act as an ordinary prudent person would act in the same circumstances.

²³ 14 ME REV. STAT. § 8102(4).

²⁴ *Id.* § 8104-B(3).

²⁵ *Conflicts of Interest and Standards of Conduct Policies: Part One*, NONPROFIT REPORT, March 2000.

The duty of loyalty "requires the director's faithful pursuit of the interest of the organization he serves rather than the financial or other interest of the director or another person or organization."²⁶ The duty of loyalty requires the director to set aside personal interests (avoid self-dealing) and make decisions based on what is best for the organization. The IRS states that a conflict of interest "arises when a person in a position of authority over an organization, such as a director, officer, or manager, may benefit personally from a decision he or she could make."²⁷ Common conflicts include board members supplying goods and services to the organizations and relatives of board members submitting bids on organization projects.

Your email indicates that the board is considering allowing directors to compete for funds being distributed by NERACOOS. A director placed in such a situation would have an obvious conflict of interest. Such a conflict should be avoided if at all possible. Although nonprofit organizations can approved such transactions, as discussed below, it is not advisable to design the organizational structure in such a way that creates conflicts.

Allowing directors to compete for funds distributed by NERACOOS might not be a problem if it only happens once in awhile. In rare situations, the interested director can be removed from the decision-making process with no adverse consequences. However, we can imagine a scenario in which multiple directors are affiliated with organizations vying for funds from NERACOOS. A number of problems could arise as these directors abstain from meetings. First, NERACOOS will have fewer directors available to review the grant proposals, which could compromise the review process. Second, directors required to abstain should not count towards a quorum, which could adversely impact the voting process. The board, however, may decide that the benefits of having such individuals on the board outweigh the inconvenience of conflicts during grant competitions.

Interested director transactions are not always detrimental to an organization. Directors can serve as the organization's lawyers and accountants, for instance, at a much lower cost than outside individuals. For that reason, many states have adopted statutes that allow nonprofit organizations to approve interested director transactions. In general, in order for a conflict of interest transaction to be properly approved, the board of directors must be

²⁶ Daniel L. Kurtz, Board Liability: Guide for Nonprofit Directors (1988).

²⁷ Internal Revenue Service, Instructions for Form 1023, 9 (Rev. June 2006).

notified in advance and the board must approve the transaction believing it is fair to the corporation.²⁸

Developing a conflict of interest policy as the NERACOOS bylaws contemplate is good governance practice. Conflict of interest policies should, at a minimum, provide three protections for the organization: disclosure, abstention, and fairness. Any conflicts or potential conflicts should be disclosed in writing to the board prior to the organization entering into the transaction. The interested director should abstain from participating in the board discussions of the transaction and voting on the matter. Finally, any transaction that involves an interested director should be fair and reasonable from the organization's perspective. The IRS's Instructions for Form 1023 contains a sample conflict of interest policy that could be adopted for use by NERACOOS.

We hope you find the above information useful. Please let us know if you need additional information or have follow-up questions. We are happy to help in any way we can.

Sincerely

Stephanie Showalter
Director

Terra Bowling
Research Counsel

²⁸ BNA Tax Management Portfolios, Exempt Organizations/Private Foundations, 872-1st: Fiduciary Duties of Nonprofit Directors and Officers, § IV - The Duty of Loyalty (2007).