DIRECTORS AND OFFICERS LIABILITY EXPOSURE FOR NONPROFIT ORGANIZATIONS

Prepared by

Dan A. Bailey
Arter & Hadden

For

National Union Fire Insurance Company
of Pittsburgh, Pa.

(NOTE: Opinions expressed do not necessarily represent.the views of National Union Fire Insurance Company of Pittsburgh, Pa. No warranty, guarantee .or·representation, either expressed or implied, is made by National Union as to the correctness or sufficiency.of any·representation contained In this publication or to its applicability to your specific situation or insurance needs.)

I. INTRODUCTION

Many people hold the common misperception that directors (including trustees) and officers of a nonprofit organization do not have a meaningful exposure to personal liability. The reality of today's tenuous legal environment is quite the opposite:

- Nonprofit D&O's may have an even more demanding job than their for-profit counterparts because the affairs of the organization may be less familiar to the individual and may be conducted under less efficient conditions than in business corporations.
- The applicable legal standards of conduct for nonprofit D&O's are at least as high, and perhaps higher than the standards applicable to for-profit D&O's.
- A variety of corporate constituents are potential claimants against nonprofit D&O's.
- Damages recoverable from D&O's of even a relatively small nonprofit organization can easily exceed the net worth of many individuals.

A surprising number of persons unknowingly face this potential exposure. It is estimated that approximately 20% of all U.S. corporations are nonprofit, thus indicating an extremely large number of nonprofit D&O's. A significant percentage of those D&O's are not business persons with experience as a director or officer nor with knowledge of their legally recognized responsibilities and duties. Even those that have such experience and knowledge frequently abandon their business approach to decision making when they enter the nonprofit setting. An appropriate risk management program to address this potential exposure is necessary not only for the protection of these potential defendants, but also for the benefit of the organization in enhancing its ability to attract the services of quality and sophisticated individuals.

II. NATURE OF NONPROFIT ORGANIZATIONS

It is difficult to address generically the liability exposure of nonprofit D&O's because of the wide variety of organizations which exist. The term "nonprofit" is somewhat misleading and extremely broad. Nonprofit organizations are generally permitted to earn a profit and, in fact, many earn substantial profits and are operated similarly to for-profit businesses. The primary distinction from a for-profit corporation is that those profits may not be distributed to members of the organization, whereas profits are distributed to shareholders of the for-profit corporation.

There are two basic types of nonprofit organizations, each with differing forms of D&O exposure. A public benefit nonprofit organization exists to serve the community at large or a segment of the community defined by criteria such as need, religious affiliation, or academic interest. Examples include churches, museums, libraries, hospitals, schools, civic groups and community improvement organizations. A mutual benefit nonprofit organization is formed to serve its members. Examples include trade associations, cooperatives, social organizations, athletic clubs and credit unions. Other variables which may affect the degree of D&O exposure include whether the organization is operated as a corporation, trust or association, whether the organization is exempt from federal income tax as either a private foundation or public charity, and the number, wealth and degree of interest of the organization's constituents.

Notwithstanding these variables, the directors and officers of all nonprofit organizations share certain common responsibilities which, if not properly discharged, may give rise to personal liability. The nature of that common exposure is discussed below.

III. FUNCTION OF A NONPROFIT BOARD OF DIRECTORS

The primary role of nonprofit D&O's is to maintain financial stability and provide the necessary resources and environment to accomplish the goals and purposes of the organization. The unique nature of nonprofit organizations presents D&O's with difficult challenges in performing this role. In many instances, fulfillment of this role is even more difficult than for D&O's of for-profit corporations.

Many for-profit corporations are subject to external forces which tend to monitor corporate performance and dictate standards of behavior. For example, securities, consumer and occupational markets tend to place deterrents on the behavior of for-profit D&O's. Reporting requirements and oversight by regulatory agencies also serve to identify and guide for-profit corporate performance and behavior. These external forces are largely absent in the nonprofit context. Accordingly, nonprofit D&O's must implement their own internal information system and performance criteria in order to timely and effectively evaluate the progress of the organization and the abilities of its management. Because nonprofit D&O's are frequently subjected to less external scrutiny than their for-profit counterparts, a greater tendency may exist to become complacent, reactive and perhaps careless in the fulfillment of their fiduciary role.

The potential for inadvertent misconduct is further heightened by the D&O's commitment to and the resources of the nonprofit organization. For many, service as a nonprofit D&O is a part-time activity with little or no compensation. In addition, the resources of many nonprofit organizations are insufficient to provide the D&O's with the most desirable support. As a result, decision making may be hindered by incomplete information, insufficient time, and inability to carefully investigate and document relevant factors.

Perhaps the most important function of the nonprofit board is the determination of the meeting's agenda. What matters the board will address and how it will allocate its limited resources are crucial issues which will likely determine the effectiveness of the board and perhaps the liability of the directors.

IV. DUTIES OF NONPROFIT D&O'S

Nonprofit directors and officers are generally subject to the same, and in some circumstances perhaps even a stricter, standard of conduct than applicable to their for-profit counterparts. D&O's of a public benefit or charitable organization may be subjected to the standards of trust law, which require the highest degree of honor and integrity and the exercise of such care and skill as a reasonably prudent person would exercise in dealing with his own property. This higher standard for public benefit corporations has been based upon a belief that such D&O's are entrusted with assets for the benefit of people who have little or no voice in selecting the management of the organization.

The current trend is to apply the somewhat less rigid standards applicable to D&O's of business corporations rather than trust standards when measuring the conduct of a nonprofit D&O. Accordingly, the following discussion summarizes those business standards as applied in the nonprofit context.

A. Duty of Loyalty

Directors and officers are required to refrain from engaging in personal activities which would injure or take advantage of the organization. They are prohibited from using their position of trust and confidence to further their private interests. This duty requires an undivided and unselfish loyalty to the organization and demands that there be no conflict between one's duty to the organization and self interest.

Conduct prohibited by this duty includes:

1. D&O's may not realize secret profits or unfair gain through personal transactions with or on behalf of the corporation.

2. D&O's may not compete with the corporation to its detriment.

3. D&O's may not usurp a corporate opportunity.

4. D&O's may not realize personal gain from the use of material, non-public information.

Examples of cases asserting claims against nonprofit D&O's for breach of this duty include:

- A trustee pledged assets of a charitable trust to obtain a personal loan.
- Chairman of the Board used the nonprofit organization as a business conduit to benefit himself.
- A trustee of a charitable hospital corporation purchased from the corporation land adjacent to the hospital, intending to build an apartment and office building on the land.
- The trustee of a hospital corporation, who was also the corporation's attorney, was paid a finder's fee in connection with a hospital transaction.
- Former president purchased land on which the organization's clubhouse was located and which the organization had taken steps towards purchasing.
- Treasurer failed to collect from the president of the organization, who was a relative of the treasurer, rents related to the operation by the president of a tavern on the organization's property.
- The trustees of a union subject to the Labor-Management Reporting and Disclosure Act authorized and received various forms of improper payments and excessive compensation.
- Alfalfa dealer, as agent for an unincorporated marketing pool for alfalfa growers, competed with the marketing pool.

Other examples of alleged breaches of this duty include disclosure to third persons of information the D&O has gained as a consequence of his position; commingling of funds; purchase by a corporate trustee of its own or an affiliated company's stock for the trust; and loans of organization funds to a D&O.

A breach of this duty of loyalty is the most frequently alleged claim against nonprofit D&O's. Such a claim frequently arises when a mere appearance of a conflict of interest exists, even though the questioned transaction was in fact on arms-length terms. It is therefore important to avoid even the appearance of such a conflict of interests.

B. Duty of Care

Directors and officers generally must act with the care that a reasonably prudent person in a similar position would use under similar circumstances. They must perform their duties in good faith and in a manner they reasonably believe to be in the best interest of the organization. Prior to making a decision, D&O's must inform themselves of all material information reasonably available to them.

This duty requires not only reasonable behavior with respect to matters submitted for approval, but also requires reasonable inquiry and monitoring of the organization's affairs. Although directors and officers are not insurers of the integrity of their subordinates or of general organizational performance, they are required to implement reasonable programs to promote appropriate organizational conduct and to identify improper conduct.

An area which particularly demands a nonprofit D&O's duty of care is the proper stewardship of the limited resources of the organization. Contribution solicitation and fund-raising activities must be conducted with honesty and accuracy and in full compliance with applicable legal restrictions. Liquid assets held by the organization must be prudently invested in light of acceptable investment risks and reasonable rates of return. Risks of loss must be appropriately managed and where necessary transferred to an insurance company or other third party risk bearer.

Examples of cases asserting claims against nonprofit D&O's for breach of this duty include:

- Trustees of a charitable organization who sold an old building that had been used to house the poor and who invested in a newer, better building were sued for wasting the assets of the organization.
- Members of a church board were sued by a church secretary alleging that the minister had

sexually imposed upon her and that the trustees were negligent in the selection of the minister and in failing to supervise his activities.

- Trustees of a private foundation allegedly refused to employ a minority person as a director, refused to grant scholarships to that person's children, and refused to provide housing and other prerequisites to that person, thereby causing damage to the person and jeopardizing the organization's tax-exempt status.
- Trustees of a private foundation were sued for furnishing goods, services and facilities to a person disqualified under applicable law from receiving those goods, services and facilities.
- Directors allegedly authorized the organization to become involved in attempts to influence legislation beneficial to the organization, thereby jeopardizing the organization's tax-exempt status.
- Directors of a charitable corporation failed to make distributions to beneficiaries, but instead placed monies in a non-interest bearing checking account for five years.
- A college and its vice president of operations were sued by a student for damages suffered when she was raped on campus.
- Museum trustees were sued for improperly storing the collection, failing to conduct annual audits, releasing a trustee from a long-term lease obligation to the museum without adequate consideration, failing to properly supervise the museum director, permitting private borrowing from the collection, failing to prevent the purchase of non-authentic art objects and permitting the facilities to fall into disrepair.

By applying as a benchmark the conduct of a reasonably prudent person in a similar position, the duty of care is a variable standard dependent upon the background, experience and expertise of each director or officer. Directorial conduct which may be acceptable for a homemaker may subject a sophisticated business person to liability. The greater one's capacity to serve, the greater the expectation of courts for that service.

D&O's are not expected to directly handle or investigate all aspects of the organization and its operations. Rather, they are permitted to delegate authority to appropriate subordinates and to rely in good faith upon officers, committees or other agents of the organization and outside experts. However, D&O's may not abdicate their responsibilities and are required to properly monitor such delegation and to select competent persons to whom full disclosure or instructions are given.

C. Duty of Obedience

Directors and officers are required to perform their duties in accordance with applicable statutes and the terms of the organization's charter. D&O's may be liable if they authorize an act which is beyond the powers conferred upon a corporation by its laws or by the state of incorporation.

Nonprofit organizations are frequently regulated by a multitude of statutes, rules and regulations with which outside directors are typically unfamiliar. For example, charitable organizations may be subject to statutes regulating fund raising and political and business activities; hospitals may be subject to complex medicaid reporting requirements; and publicly supported organizations may be subject to unusual terms and restrictions in various grant and financial assistance documents. If directors and officers cause the organization to violate these legal requirements, personal liability for the resulting loss to the organization may exist.

Tax-exempt organizations are particularly subject to a myriad of restrictions and requirements. For example, D&O's may jeopardize the organization's tax-exempt status if its earnings privately inure to the benefit of any individual, if it is operated for non-charitable purposes, if it engages in certain types of political or legislative activities, if it fails to file or obtain required returns or certificates or if as a private foundation it violates any of a series of rules prohibiting the appearance of self dealing, large business holdings and the like. Loss of tax-exempt status may not only injure the organization, but may jeopardize the deductibility of contributions to the organization, thereby causing harm to the donors.

Informally operated organizations also risk a claimant successfully piercing the corporate veil and obtaining recovery from D&O's and perhaps other members for the obligations of the organization. The corporate veil may be pierced if there is such unity of interest and ownership that the separate personalities of the organization and the individuals no longer exist and if adherence to the fiction of separate existence would sanction a fraud or promote injustice. D&O's should operate the organization as a separate legal entity, recognizing all the appropriate corporate formalities and avoiding any appearance that the assets or operations of the organization are commingled with the assets or personal dealings of the directors and officers.

In addition to obeying the laws, formalities, and separate existence of the organization, directors and officers must also obey a variety of laws which may impose direct liability upon the D&O's for wrongful conduct. Examples of statutorily imposed liability on nonprofit D&O's include:

1. Employment Claims. Claims against nonprofit D&O's by employees of the organization may allege wrongful discharge or discrimination based upon, for example, the sex, race or age of the employee. The frequency of these types of claims have increased dramatically in recent years and courts often apply liberal standards in establishing liability and measuring damages. These claims usually are highly emotional and therefore may be expensive to defend even if no wrongful conduct occurred.

2. Antitrust Claims. A variety of nonprofit organizations, including associations, cooperatives, and other organizations in which competitors or businesses with mutual interests are members, face potential antitrust exposure for the individuals involved. Formal or informal discussions of any kind relating to prices that are or will be charged for products or services, allocation of customers or territories, or boycott of particular suppliers or groups of suppliers, are strictly prohibited and subject the individuals to antitrust liability, including treble damages. Certain conduct constitutes a per se violation of the antitrust laws regardless of the person's intent. Any conduct which in any way appears to restrict, eliminate or govern competition should be avoided.

3. Copyright/Patent Claims. D&O's who actively and consciously permit the organization to infringe a copyright or patent may be held personally liable for such infringement. For example, illegal showings of videotapes of copyrighted movies or illegal distribution and use of copyrighted music and other materials may create personal D&O exposure.

4. Defamation Claims. Directors and officers of organizations which publish and distribute materials or sponsor or promote public speaking activities have potential liability exposure from defamation claims by persons who believe they have been libeled or slandered as a result of communications by the organization and its directors and officers.

5. ERISA Claims. The Employee Retirement Income Security Act of 1974 ("ERISA") imposes potential liability on individuals classified as "fiduciaries", including officers and directors who exercise any discretionary authority or responsibility in the administration of an employee benefit plan covered by the Act. This liability may be based upon a breach of fiduciary duties imposed by ERISA or for permitting certain prohibited transactions.

6. Pollution Claims. Knowing violations of the various state and federal pollution laws may create personal liability for a director or officer. These laws have potential applicability to a surprising number of organizations which either own property on which a pollution problem exists or which create waste regulated by these laws (such as medical waste).

7. Credentialling Claims. Hospitals and other organizations which credential professionals subject their directors and officers to potential claims if a professional believes those individuals denied the requested credentialling unfairly or improperly.

8. Professional Liability Claims. Organizations through whom professional services are rendered and their directors and officers are exposed to claims for professional malpractice. Even if the directors and officers are not professionals themselves, liability may exist if they improperly supervised and monitored the performance of the professional or the provision of the professional services.

9. Securities Law Claims. A wide variety of seemingly innocuous activities by nonprofit organizations have been held to be securities transactions, thus subjecting the organization and its directors and officers to potential securities liability exposure. For example, various kinds of memberships and initiation fees, applications offering a share in profits, mortgage bonds, pooled income funds and scholarship trust funds have been viewed as securities by courts. In addition, directors and officers who engage in deceptive or manipulative conduct in connection with the sale or purchase of securities on behalf of the organization create liability exposure. Many nonprofit organizations are exempt from some provisions of the federal securities laws, although potential exposure remains in various areas for many organizations.

10. Miscellaneous State Statutes. Most states have a variety of statutes which may impose personal liability on nonprofit D&O's for, among other things, exceeding their corporate authority, participating in the making of loans to officers or directors, distributing assets contrary to law, distributing assets to non-creditors during dissolution without paying all known debts, making distributions to members when the corporation is (or which caused the corporation to be) insolvent, making false entries in books and records, preparing, delivering or publishing false documents, preparing or signing false documents filed with the state, and failing to answer interrogatories propounded by state officials.

D. Liability Limitation Statutes

Since 1985, a number of states have enacted statutes which purport to eliminate or limit certain types of nonprofit D&O liability exposure. These statutes vary greatly and require close examination to determine their true benefit. None of the statutes create absolute immunity for the directors and officers. For example, none of the statutes impact any liability based upon a federal statute or rule. Many of the statutes limit their benefit to non-compensated volunteers and therefore any person receiving any form and any amount of compensation obtains no benefit from such a statute. Many of the statutes expressly do not apply to a breach of the duty of loyalty, which is perhaps the most frequently asserted claim against nonprofit D&O's. Also, many of these statutes apply to only a limited type of nonprofit organization, such as a charitable or some form of tax-exempt organization. The validity and interpretation of these statutes have not been addressed by courts to date. Even if the liability limitation applies, the directors and officers may still be subjected to defending the claim and funding the costs associated with that defense.

V. POTENTIAL CLAIMANTS

One of the greatest misperceptions concerning the potential liability exposure for nonprofit D&O's is the erroneous belief that because a nonprofit organization has no shareholders, no one is likely to bring a D&O claim. Recent surveys of for-profit corporations indicate that approximately 50% of all D&O claims reported in the surveys were made by claimants other than shareholders. Although these surveys admittedly do not report nonprofit D&O claims, they do verify that substantial D&O exposure exists to third parties who are not shareholders in the corporation. In addition, virtually every nonprofit organization exists for the benefit of some group of constituents. Directors and officers owe fiduciary duties to those constituents much as directors and officers of for-profit corporations owe fiduciary duties to shareholders.

The following briefly discusses the various classes of potential claimants in a nonprofit D&O claim:

1. Organization. A claim by the organization itself against its directors or officers typically takes one of two forms. If brought directly by the organization, it must be approved by management of the organization and therefore will likely be made against former directors and officers rather than incumbent D&O's. Most states also permit nonprofit derivative suits pursuant to which a member of the organization may assert a claim on behalf of the organization against a director or officer.

2. Directors. Directors of a nonprofit organization may sue fellow directors for a violation of the directors' duties to the corporation. In fact, the duties of a director may compel such a suit in appropriate circumstances.

3. Members. Members may sue directors and officers to protect their special interests, including the right to an effective vote, the right to have new members chosen in accordance with corporate documents, the right to have the purposes of the organization fulfilled, the right to have the organization continue in existence and the right to have the organization managed free of conflicts of interest. Like shareholders, though, members may not directly sue directors for alleged mismanagement which damages the corporation, but not the unique interests of the member.

4. Beneficiaries. Recipients of the services of the nonprofit organization may be permitted to assert claims against the directors and officers, particularly where the beneficiaries have been personally affected by the alleged wrongdoing.

5. Donors. A donor to a charitable organization may have standing to sue the directors for misapplication of the donor's gift or for departing from the stated purposes of the organization.

6. Outsiders. Outside third parties who transact business or otherwise deal with the organization may assert a D&O claim if such outsider has been personally and directly harmed by the wrongdoing or if a particular statute or law recognizes such standing.

7. Attorney General. Most state statutes recognize the power and duty of the state attorney general to supervise the activities of charitable organizations and to enforce their purposes and proper administration. This power typically includes the authority to assert claims against directors and officers of the charitable corporation. The attorney general in such claims represents the interests of the general public in assuring appropriate management of the public benefit organization.

8. Other Government Officials. If directors and officers allegedly violate specific state or federal laws, other government officials charged with the administration of those laws may also assert a D&O claim.

VI. D&O FINANCIAL PROTECTION

Nonprofit directors and officers are clearly exposed to potential liability, although that exposure is admittedly less than the exposure for directors and officers of for-profit corporations. Because of that exposure, it is incumbent upon those D&O's to maximize the financial protection available to them in the event a claim is asserted.

There are two methods by which a nonprofit organization can provide financial protection to its D&O's: indemnification and insurance. Every state by statute permits nonprofit corporations to indemnify their directors and officers against loss incurred as a result of certain types of claims. However, such indemnification does not provide protection in all instances. For example, indemnification may not be available to the director and officer for the following reasons:

1. The organization may become insolvent or may not have sufficient resources to pay the losses and expenses incurred by the directors and officers.

2. Either the applicable law or the corporation's internal indemnification provisions may be modified to limit or prohibit the expected indemnification.

3. The composition or attitude of the organization's board of directors may change so that the board is no longer sympathetic to the prior officer or director and thus does not make the necessary determinations to authorize the indemnification.

4. As a matter of policy, the organization may deem it inappropriate to use contributed funds for such indemnification.

5. Because of public policy considerations and statutory limitations, some claims may be insurable but not indemnifiable. For example, damages other than attorneys' fees incurred by directors and officers of a private foundation may be considered prohibited self-dealing and settlements and judgments in derivative suits may not be indemnifiable in many states.

D&O insurance can help provide protection to the directors and officers for all of these non-indemnifiable exposures and thus can offer a more comprehensive financial protection program for the D&O's. In addition, D&O insurance transfers to the insurer the organization's financial risk of funding its indemnification obligation.

As an alternative or supplement to the nonprofit organization obtaining D&O insurance, directors who are serving the organization at the request of another corporation may obtain insurance coverage through D&O insurance purchased by the requesting corporation. This coverage provides protection only for the person who has been requested to serve the nonprofit organization.

D&O insurance is somewhat unique in nature and creates complex legal; underwriting and management issues which are difficult to identify and analyze without the assistance of knowledgeable experts. This important product should be obtained from insurers which have significant nonprofit underwriting and claims experience and which are likely to remain a viable D&O insurer into the foreseeable future.