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Maximizing Legal Protections for Directors of Nonprofit Corporations: A Timely Topic in Today's Dangerous World

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Much like their counterparts on the boards of public companies, board members of many nonprofit corporations increasingly, and quite understandably, are raising questions concerning their potential personal liability and the steps that may be taken to maximize their protection against such liability. The impetus for these questions is not difficult to discern and includes, among other things:

- the assertion of claims against board members of health care institutions;
- the publicity concerning financially-related problems at a variety of reputable nonprofit and charitable organizations;
- bankruptcies of nonprofit organizations which bankruptcies can and sometimes do lead to claims against directors;
- the creativity of plaintiffs' lawyers in seeking to hold board members personally accountable for losses arising out of financial problems of the organization and the misconduct of insiders. The fact that a director of a nonprofit organization was well-intentioned may no longer dissuade such lawyers from asserting claims;
- increasing scrutiny by state attorney generals that are empowered to oversee nonprofit organizations; and
- the increasing use of financing, e.g., bond offerings, that can give rise to securities claims similar to those asserted against public company directors.

At the outset, it is important not to lose sight of the larger context and, in particular, the significant differences between the liability exposure faced by directors of public companies and that faced by directors of nonprofit organizations. The principal driver of claims against public company directors is liability imposed under the federal securities laws. The paradigmatic claim is one brought by shareholders contending that they purchased shares of a public company at an inflated price based on alleged misrepresentations in public filings and other public documents. A drop in the share price of a public company allegedly connected to such misrepresentations can and sometimes does lead to claimed damages in the millions or billions of dollars.

Directors of nonprofit organizations simply do not face this type of liability risk, because, among other things, nonprofit corporations do not have shareholders that are seeking a financial return. Instead, directors of nonprofit corporations are sometimes subject to claims by the Internal Revenue Service or attorney general alleging that a director or some other insider has inappropriately benefited from his, her or its relationship with the nonprofit corporation. In addition, they are also subject to occasional employment practices claims.

In response to the developments noted above and in an effort to ensure that they retain qualified board members, a growing number of nonprofit corporations – particularly those with substantial assets or

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"high net worth" board members or engaged in high-risk activities – are undertaking a legal review to ensure that appropriate legal protections are available to their board members. In this regard, some nonprofit corporations, such as major universities, health care institutions, and other charitable organizations, have sought the assistance of law firms with specialists who concentrate their practice in the areas of insurance coverage and nonprofit law.

D&O INSURANCE

One of the most basic, but least appreciated, facts of relevance to nonprofit board members is this: the terms of coverage provided by D&O insurance contracts are not the same. Rather, they differ in numerous respects, and those differences matter. They can determine whether the director is covered for a claim asserted against him or her or whether the director is not covered and therefore potentially personally responsible for paying attorneys' fees and the cost of any settlements and judgments in connection with a third-party claim against the director.

For years, insurance brokers have played a nearly exclusive role in advising nonprofit corporations on D&O insurance matters, including reviewing and negotiating the terms of coverage. For a growing number of nonprofit corporations, this practice is changing. D&O insurance contracts, after all, are fundamentally *legal* documents. The meaning, and the value, of a D&O insurance policy is ultimately determined by rulings of a court/arbitrator, by a verdict of a jury, or more commonly by what the parties expect such rulings or verdicts will be. Accordingly, nonprofit organizations increasingly are seeking the assistance of legal counsel, experienced in such insurance coverage matters, to review the proposed policy wording, to recommend wording improvements, and to collaborate with the broker and the nonprofit corporation in securing appropriate D&O insurance protection. In many instances, the terms of coverage can be enhanced, if, but only if, the nonprofit corporation knows what to ask for – before the coverage is placed.

Among the D&O insurance questions of greatest interest to nonprofit corporations and their directors are the following:

- *Adequacy of Limits*. Are the policy limits adequate, taking into account, among other things, the fact that defense costs typically count towards exhaustion of the policy limits?
- *Priority of Payments*. If it turns out that the policy limits are insufficient to satisfy all of the claims for coverage, do the directors' rights to be paid under the policy take priority over those of other insureds, especially those of the nonprofit itself? This is particularly important given that the typical nonprofit D&O policy covers many insureds besides the directors and covers risks besides D&O liability (e.g., the nonprofit's employment practices liability).
- *Voiding the Policy*. Is the director protected against the risk that the policy will be rescinded as to him or her simply because, unbeknownst to the director, there are misstatements in the insurance application?
- *Choice of Counsel*. Will the director be entitled to choose appropriate counsel to defend against a claim, or will the director be required to use potentially less effective counsel chosen by the insurer (often to reduce the cost of defense)?
- *Bankruptcy Claims*. If the nonprofit corporation becomes insolvent and a derivative claim is asserted on behalf of the debtor entity alleging that the director breached various duties to the nonprofit corporation, does the "insured versus insured" exclusion preclude coverage for the director?

- *ODL Coverage*. If the director is employed by another organization, does the director have outside director liability ("ODL") coverage under his or her employer's D&O policy?

For some directors, the answers to these potentially important questions are favorable; for many others, the answers unfortunately are not.

LIMITATION OF LIABILITY

To reduce the risk of liability to its directors, a nonprofit corporation should include in its governing documents language providing that a director will not be liable to the extent liability may be limited by law. Often this will mean that a director will not be liable for actions or omissions that are merely negligent and that, to prevail, a plaintiff must be able to demonstrate that, at a minimum, the director's action or omission was reckless, willful or criminal. While such a provision will not dissuade every plaintiff from bringing an action against the director, it does raise substantially the burden that the plaintiff must satisfy to obtain relief, thereby perhaps allowing the director to defend himself or herself successfully.

INDEMNIFICATION

In the event of a claim, the first level of protection for the director of a nonprofit corporation is, of course, not the D&O insurance contract, but rather the nonprofit corporation itself and its indemnity obligation to the director. Yet, as is the case with D&O insurance policies, the extent and nature of the indemnity rights available to directors varies, depending on both the precise wording of the relevant documents providing indemnification and the applicable law. Many nonprofit corporations and their directors not surprisingly are re-examining the indemnity protections available to the directors in these more perilous times.

The issues of interest include the following:

- *Mandatory or Permissive.* Does the indemnification language require that the corporation indemnify the director or merely permit it? What are the standards that must be satisfied? How does the director seek indemnification? Does the language provide for indemnification in connection with actions brought against the director on behalf of the corporation?
- *Advancement.* Does the indemnification language require the corporation to advance funds to the director prior to a final resolution of the matter? Or, must the director bear defense costs until the matter is settled or adjudicated?
- *Available Assets.* Does the corporation have sufficient unrestricted assets to satisfy its indemnification obligations to all parties entitled to be indemnified? If not, how are available assets allocated among those entitled to indemnification?
- *Separate Contract.* When and how can the provisions in the governing document be changed? Should the director seek a separate indemnification agreement with the corporation?

BEST PRACTICES

The boards of many nonprofit corporations are pursuing what many informed observers believe to be the best first line of defense: they are assessing the policies and practices of the nonprofit organization with an eye toward identifying and implementing policies and practices designed to demonstrate that the directors are fulfilling their duties of care and loyalty. Items that might be addressed include:

- *Conflict of Interest Policy*. Does the corporation have an adequate conflict of interest policy? Does it comply with it? Who monitors compliance?
- *Restricted Funds.* How does the corporation handle its restricted funds? Do policies and practices assure that restricted funds are always used and invested as required by law?
- *Gift Acceptance, Spending and Investment Policies.* Does the corporation have and follow policies and practices that assure it accepts only gifts that do not pose undue risks? Does the corporation have a spending policy assuring that endowment and trust funds are spent only as permitted by law? Does the corporation have an investment policy regarding how and by whom its funds are invested? Is the policy adequate to demonstrate that the directors are exercising their fiduciary duty regarding invested assets?
- *CEO Compensation.* Who determines CEO compensation? Is the compensation reasonable? How does the board know that?
- *Employment Policies and Practices.* Does the corporation have and follow practices and policies intended to assure that its employment practices comply with law?
- *Board Information.* Do directors receive financial and other information sufficient to enable them to understand the corporation's finances and operations and make prudent decisions? Are directors readily able to secure any additional information that they require? Do directors actually review and understand the information? Do directors reach an independent conclusion based upon the information provided to them rather than "rubber-stamping" management recommendations?
- *Board Composition and Participation.* Does the board include persons with the necessary expertise? Do all directors actively participate in the work of the board? Is the board so large that some directors feel disenfranchised?
- *Governance Structure of the Board.* Does the board have an appropriate committee structure? What is the nominating process? Are appropriate meeting practices in place?
- *Audit Practices.* Does the board obtain an annual audit from an independent auditor? Does the auditor report to the board or the staff? Are adequate internal controls in place?
- *Licenses and Filing.* Does the corporation timely file its Form 990 and all required employment forms and timely remit all employment taxes? Is the corporation appropriately registered to solicit charitable contributions?
- *Whistleblower and Document Destruction Policies.* Does the corporation have and follow satisfactory policies regarding whistleblowers and destruction of documents?

The preceding list is not, and is not intended to be, an exhaustive description of all matters that a nonprofit corporation and its prudent and diligent board might wish to consider. However, it is hoped that the list will assist nonprofit corporations and their boards in addressing this timely subject. To summarize: first, sound and well-considered practices and policies will reduce the risk that claims against directors will be asserted and, if asserted, will be successful; and second, suitable and carefully-reviewed indemnification and limitation of liability provisions and D&O insurance terms will enhance the protections afforded to any director that becomes subject to a claim.

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