Reduce Your Risk of Liability

Worried about being sued as a board member? Here's what you need to know.

BY DONALD W. KRAMER

Nonprofit board members often worry about being sued. Although relatively few nonprofit board members have actually been sued for their conduct as board members—and far fewer have ultimately been found liable for damages—their concern about personal liability is real and pervasive.

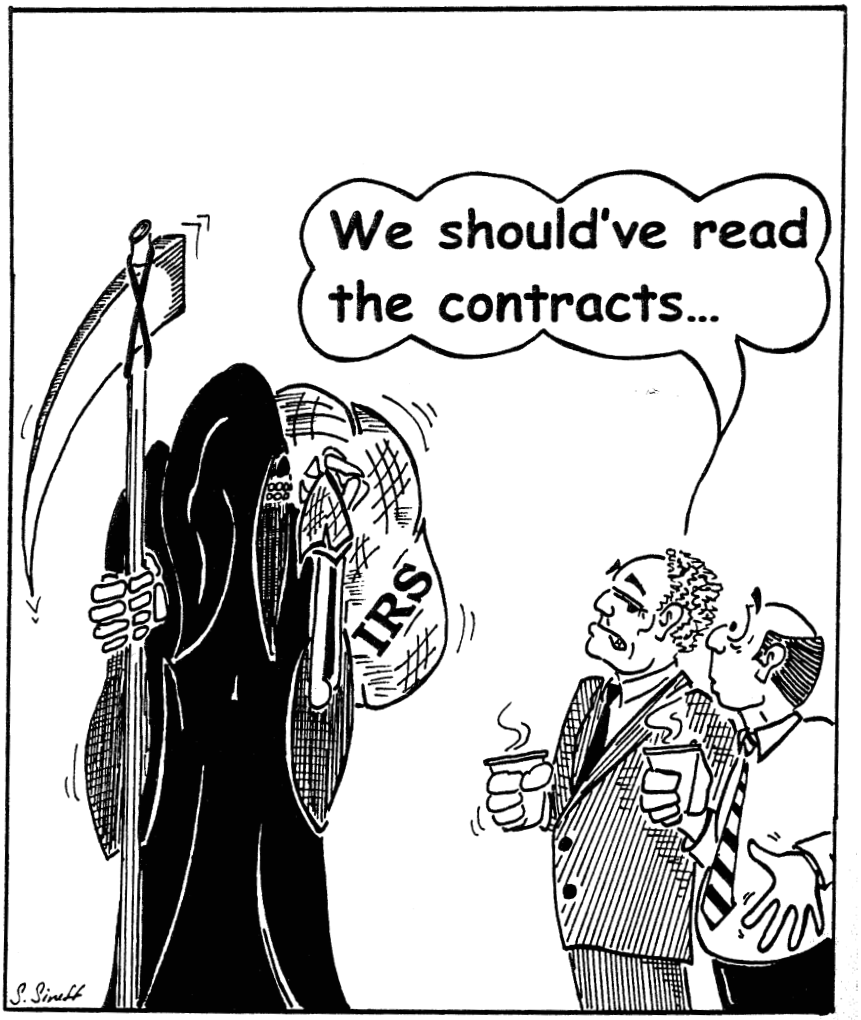
Organizations that want to attract and keep good board members take pains to be sure that the board members' personal exposure is reduced. Changes in state and federal laws in the last decade and an increasing sophistication in purchasing insurance have given nonprofits a greater ability to provide protection for their board members and their organization.

Board members are properly concerned about two kinds of liability:

1. Protect Yourself against Personal Liability

Board members' first concern is about personal liability. They worry about being held liable for damage to a third party arising from their acts or omissions on behalf of the organization. This type of "tort" liability is much the same as they face in their daily activities, where they can be sued for negligent driving that causes an auto accident, for example.

Most nonprofit organizations are corporations, and one benefit of the corporate form is its limitation on personal liability. Normally, an individual isn't personally liable for a breach of contract or other improper conduct of the organization itself, or for that of other employees or agents of the corporation.



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The protection doesn't apply, however, to the personal conduct of the individual. Individuals are responsible for their own actions.

A board member of a nursing home wouldn't ordinarily be personally liable, for example, if a nurse's aide dropped a resident while trying to transfer the resident to a wheelchair. Although the home might be liable for the negligence of the aide, the board members wouldn't be personally liable for the aide's conduct.

If, however, the board had decided not to train the nurse's aides in how to make such transfers, knowing that the failure to train created a risk of harm for the residents, a member of the board who had agreed with that decision might be personally liable for the resident's injury.

The classic case of personal responsibility was illustrated by a suit involving a California condominium association in the mid-1980s. A resident complained that the outside lighting was inadequate to deter someone from breaking into her first-floor unit. The board decided not to increase the lighting. When the woman added her own lights, the board turned off her lights and the previously existing lights as well. An intruder broke into the woman's unit and assaulted her.

When the woman sued, the court said that the board members could be sued personally because they had affirmatively decided to shut off the lights and the injury was a foreseeable consequence of that decision.

(A board member who disagrees with a decision such as this should be sure that the minutes of the board meeting record the disagreement and the negative vote. A dissenting board member shouldn't be personally liable if the decision later proves to have been a bad one and the board members who made it are sued.)

Whether a board member is ultimately held personally liable for an injury in a case such as this may depend on the standard by which the board members' conduct is measured. Most board members of charities are volunteers and thus are protected by the Volunteer Protection Act. This 1997 federal law provides that volunteers for charities won't be personally liable for their acts or omissions if they are acting within the scope of their responsibility for the organization and the harm is "not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of others."

The federal law doesn't protect the volunteer from liability for injuries caused by the operation of a motor vehicle. Nor does it relieve the organization itself from liability for the negligent or improper acts of its volunteers.

The best protection against personal liability comes from liability insurance. Board members are almost always included as named insureds under general and professional liability policies maintained by nonprofits. Even if the board members haven't acted improperly, the insurance will provide their legal defense. If the cost of paying the defense lawyer is the personal responsibility of the board members, that amount alone, even without ultimate liability for damages, could be ruinous.

2. Protect against Breach of Fiduciary Duties

A second concern for board members is liability to the organization and its members for failing to perform their fiduciary duties. These duties include the following:

The duty of loyalty states that board members may not put their own interests ahead of the interests of the corporation. The most obvious areas of danger involve economic conflicts of interest. Some boards take the position that they will have no financial dealings with any member of the board. Most, however, aren't absolute so long as the conflict is disclosed before the transaction is entered into, the deal is fair to the corporation, and the arrangement is approved by the majority of disinterested members of the board.

Because so many charities depend on public support, the disclosure of improper private benefit to an insider can undermine the organization's credibility and cripple its programs. The question of impropriety, even when the conduct is disclosed and legal, can cause problems when portrayed in an unfavorable light by an investigating reporter. In extreme cases, insider scandals have hurt the credibility of the entire nonprofit sector.

Nonprofits should develop conflict policies that, at the least, require the disclosure of any potential conflict and the approval of any transaction by a disinterested majority of the board.

This issue is even more important now because Congress has given the IRS the power to impose an "excess benefits" tax under the "intermediate sanctions" provisions added to the Tax Code in 1996 (see Fram and Schmidt in "Resources.") The IRS may impose a tax on "disqualified people" who receive benefits from the charity in excess of the value of the goods or services they provide in return. "Disqualified people" include board members and anyone else in a position to exercise substantial influence over the affairs of the corporation.

The statute was passed primarily to curb unreasonable compensation for executives, but it is broad enough to cover any arrangement with a disqualified person. An excessive fee for a professional service from a board member, payment for a spouse to travel with a board member to the national convention, or any other economic advantage of any kind may be taxable.

The duty of care is usually spelled out in the state nonprofit corporation law. Although the exact wording may vary, this statute says that board members have a duty to act in good faith, in a manner they reasonably believe to be in the best interests of the organization, and with such care–including reasonable inquiry, skill, and diligence–as a person of ordinary prudence would use under similar circumstances.

Financing operations with withholding taxes is a huge personal risk.

Each of these phrases could be the subject of litigation, and the statute usually gives guidance on how to avoid such litigation. Many statutes provide, for example, that a board member may rely in good faith on information presented by officers or employees of the corporation, by counsel, public accountants or other professionals, and by committees of the board, so long as the board member reasonably believes them to be reliable and competent. Board members aren't acting in good faith if they rely on a report with knowledge that the reliance isn't warranted.

In effect, these statutes have created a slightly expanded "business judgment rule," which has traditionally protected board members from personal liability when their actions have been reasonable and in good faith. Courts have been reluctant to impose personal liability on board members merely because a decision turns out to have been a bad one, as long as they acted reasonably in making the decision in the first place.

(One area in which nonprofit board members can legitimately lose sleep at night is the organization's failure to pay federal—and sometimes state—payroll withholding taxes. A person "responsible" for those payments may be personally liable if they aren't paid. Court cases make clear that mere knowledge that these taxes aren't being paid may be enough to create personal liability. It is natural to want to pay the loyal staff and continue the program even when the money gets tight. But financing those operations with withholding taxes is a huge personal risk.)

Protect Yourself through Indemnification

What happens if a board member is sued for injury to a third party for an alleged breach of fiduciary duty? The board member looks to the corporation for "indemnification" against personal loss, for protection for the payment of attorneys' fees and other lawsuit costs, amounts for settlement, and, in many cases, even payment of adverse judgments.

Indemnification rights are largely created by state statutes. Although the language varies, most state laws include the following information:

• **Indemnification usually applies to investigations** or other "proceedings" —civil, criminal, and administrative— whether pending or "threatened" and isn't limited to actual litigation. It usually covers claims against board members in their capacity as representatives of the organization.

• **The corporation is usually *required* to indemnify a board member** who is "successful" in defending against a claim. The statutes permit voluntary indemnification in many other cases, such as when the board member settles the claim and, in certain situations, even when the board member is found liable.

• **Indemnification can cover settlements** and often fines and judgments.

• **To be entitled to indemnification, board members must have acted in good faith** and in a manner they reasonably believed to be in the interests of the corporation.

• **Indemnification is usually prohibited** if board members have been found liable to the corporation itself for breach of duty in a so-called "derivative suit" on behalf of the corporation. It makes no sense for the corporation to give board members money which they will just have to pay back to the corporation because of their improper conduct.

• **Most statutes say that no indemnification may be made** until a determination is met in each case in which the board member meets the qualification for indemnification. The determination must be made by a quorum of board members who are not involved in the proceeding or, if such a quorum is unavailable, by an independent attorney.

• **The corporation may advance board members' legal-defense costs** as long as they meet the qualifications for indemnification and promise to repay the money if it is ultimately determined that they aren't entitled to it.

To some extent, these obligations and rights are included in the law of the state in which the nonprofit is incorporated. Savvy board members, however, will want to see specific provisions granting them the maximum protection included either in the articles (or certificate) of incorporation or in the organization's bylaws. These documents act as a form of contract between the corporation and the board member and provide greater assurance of protection.

Be Sure You're Protected through Insurance

How does a nonprofit back up its promise to indemnify? Unless it has substantial assets of its own, the answer is insurance. General and professional liability insurance usually covers bodily injury or property damage to other people. Directors' and officers' (D & O) insurance provides protection against claims of breach of fiduciary duty and other wrongful acts.

(Board members may be covered under plans maintained by their employers or under "umbrella" policies maintained for excess coverage under their personal homeowners or automobile policies. The nonprofit board, however, should do what it can to

provide adequate protection through the organization.)

Here are some things you should know about D & O insurance:

D & O insurance was traditionally written to provide two areas of coverage: (1) It covered the individual board members and officers, and (2) subject to certain exclusions, it would pay their litigation defense costs and settlements if they were sued. It also reimbursed the corporation to the extent that the corporation advanced such payments.

Traditionally missing from the coverage was protection for the organization itself for the wrongful acts of its representatives. With the expansion of volunteer protection acts and director liability laws, it is possible, even likely, that an individual would not be personally liable for an action but that the corporation would be liable for the results of the action.

The president of the board might not be personally liable, for example, for a discriminatory termination of the executive director if the president's actions weren't willful misconduct or recklessness. But the corporation could still be liable for the wrongful conduct of its officer.

Most modern policies now cover the organization itself. Be sure your organization's policy includes such coverage.

Be careful about exclusions in the policy. Insurance companies don't want to cover the costs of a grudge match when one faction of the board sues another faction over a matter of "principle." Most policies, therefore, contain some form of "insured versus insured" exclusion, denying coverage when one person who is named as an insured person sues someone who is also a named insured.

Most nonprofits want to provide protection for as broad a group as possible, including present, former, and future board members, committee members, and other volunteers. But these individuals are the most likely to start a suit because they're the ones who care most about the organization. Without proper tailoring of the exclusion language, protection can be undercut by expansive coverage of individuals.

Nonprofits must also be aware of attempts to exclude coverage of employment disputes, which create the largest single category of claims under D & O policies. Make sure your policy includes such coverage, including protection against claims of discrimination, wrongful termination, and other charges by employees (see Mahoney and Sills in "Resources").

Be sure your policy advances the costs of legal defense before the final outcome of the litigation or proceeding. With the expense of litigation today, it may be impossible for an individual to carry the burden of defense costs to the conclusion of the case.

Make certain that non-monetary claims are covered by the policy. If someone sues for access to financial books and records, for example, the policy should cover the defense of that claim.

Work with a knowledgeable broker who can advise your organization on the amount and scope of your coverage. D & O insurance has become more available in recent years and can usually be obtained at reasonable rates. If an experienced insurance broker isn't available locally, a national or state association of similar nonprofits can help you find someone.

Insurance is invoked only when there is a problem. If the coverage isn't right, it's too late to change your policy after the claim is filed.

Board Risk Management

Beyond insurance, how do board members protect themselves from potential liability? By running a strong program, showing up at meetings, paying attention, acting in good faith, and using their best judgment in pursuit of the organization's mission.

The object of serving on a board isn't to avoid liability. The object is to advance the organization's mission and make the world a better place.

That requires proactive measures, not defensive tactics. The likelihood of doing the job is enhanced with a diverse board of individuals who aren't afraid to ask "dumb questions," who actively present different points of view, who remember the reason they are there, and who are willing to act. ■

Resources

Fram, Eugene & Elaine Spaull, "Expectations for Nonprofit Boards Are Changing," *Nonprofit World*, Vol. 19, No. 3.

Lapin, David, Donald Grunewald, and Barbara S. Frees, "Choosing the Right D & O Insurance for Your Board," *Nonprofit World*, Vol. 12, No. 1.

Mahoney, John, "Protect Yourself Against Employee Lawsuits," *Nonprofit World*, Vol. 15, No. 2.

Schmidt, Sarah, "New Regs Unravel Intermediate Sanctions Snares," *Nonprofit World*, Vol. 19, No. 4.

Sills, Stephen & Scott H. Smith, "The Emperor's New Clothes, Or How to Protect Against Lawsuits and Other Chilling Surprises," *Nonprofit World*, Vol. 13, No.

Weisman, Carol, *Board Governance Videotape.*

These resources are available through the Society's Resource Center, www.snpo.org.

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