Directors and Officers (D&O)

Key Facts About Insurance and Legal Liability

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Introduction

Who should read this booklet?

The information in this booklet is based on dozens of presentations we have made across the country to nonprofit managers and board members of 501(c)(3) nonprofit organizations. This booklet is designed for a similar audience. It incorporates the questions and concerns most commonly expressed by those who have attended these sessions.

Specifically, this booklet is designed to help ANI and NIAC nonprofit members understand some of the most basic coverages provided by directors and officers insurance and to help them avoid lawsuits against their board members and organizations when possible. It briefly reviews the federal law that offers minimal protection for volunteers and explains why, for most nonprofits, directors and officers liability insurance is a valuable risk financing tool.

This booklet does not provide legal advice, nor does it provide detailed information on any particular directors and officers liability insurance policy. We urge you to consult with legal and insurance professionals for assistance with this type of information. However, we hope this booklet will help you gain a better understanding of some of the key issues surrounding the topics of board liability and D&O insurance and enable you to take appropriate steps to protect the valuable assets of your nonprofit.

Chapter 1

Directors & Officers Liability Insurance: Where does it fit into the overall insurance picture?

It was summer and Yourtown Community Center was at its peak. The organization's new programs were in high demand, community donations were up, and the Center had just completed construction of a new recreation facility. The board of directors had no warning of what was coming next—a lawsuit.

Served in late June, the lawsuit alleged that the executive director was liable for sexual harassment and discrimination. Damages in excess of $500,000 were sought. Shaken, the board turned the lawsuit over to its insurance broker expecting the Center's general liability insurance carrier would defend the claim. At the next meeting of the board, the broker read a letter from the insurance company informing the organization that there was no coverage for employment-related claims under the general liability policy and that they should look for coverage under their directors and officers liability policy. The directors looked at each other with pained expressions. They had previously decided not to purchase directors and officers liability insurance and to devote all available resources to the expansion.

Although the details vary, that story happens all too frequently. What's worse is that sometimes boards with the foresight to purchase directors and officers (D&O) insurance fail to purchase a policy containing the broad coverages they need.

Because we have seen too many situations like the one illustrated above, this booklet is not about helping you to decide whether to purchase D&O insurance. It is intended to help you understand the need for this type of coverage, help you evaluate your various coverage options and, if possible, help you avoid lawsuits of this nature. Whether you have D&O insurance or not, becoming embroiled in a lawsuit will strain your organization and stress your employees. The best course is avoidance whenever possible.

The following section explains the distinction between general liability and directors and officers liability coverage. Remember that while general liability policies are substantially similar from one policy form to the next, there are often significant differences in the coverages provided by D&O policies. These comments are therefore very general regarding these coverages and reflect what's typically found in policy forms.

General liability insurance...

...provides coverage for "negligent" acts. "Negligence" is doing something a reasonable person would not do under the circumstances or failing to do something a reasonable person would do. If your organization or its employees or volunteers (including board members) negligently cause someone "bodily injury, personal injury or property damage" general liability insurance provides coverage. If someone is physically injured or his/her reputation is hurt, or another person's property is damaged because of a mistake by someone at your organization, you can usually rely on general liability insurance for coverage. For example, if/when a client trips and breaks a leg because of a faulty stairway at the nonprofit.

Directors and officers (D&O) liability insurance...

...provides coverage for "intentional" actions taken by an organization's board of directors or managers that someone else thinks are wrong. In an employment-related case, the board affirmatively adopts personnel policies which are intentionally carried out by management. These are intentional, willful actions that may result in some type of damage other than bodily injury. For example, if/when an employee is terminated and alleges age discrimination. However, even though D&O coverage generally provides defense against allegations of wrongful acts, such as harassment and discrimination, it is not possible to purchase insurance for willful, illegal acts.

Chapter 2:

Commonly Asked Questions. Things every director & officer should know

Directors and officers owe three basic fiduciary duties to the nonprofit organizations they serve: the duties of obedience, loyalty and due care.

1. The duty of obedience forbids acts outside corporate powers. The governing board of the organization must comply with state and federal law, and conform to the organization's charter, articles of incorporation and bylaws.

2. The duty of loyalty dictates that officers and directors must act in good faith and must not allow their personal interests to prevail over the interests of the organization.

3. The duty of care requires directors and officers to be diligent and prudent in managing the organization's affairs. The individuals charged with governing must handle the organizational duties with the care that an ordinarily prudent person would use under similar circumstances.

For many years, directors and officers of nonprofit organizations enjoyed a sense of invulnerability because their services were associated with a nonprofit and not an attractive target for litigation. Nonprofit board members who continue to believe they are invulnerable today may be in for an unpleasant surprise.

The duties of corporate governance—obedience, loyalty and due care—may seem high-minded. However, the importance of these responsibilities becomes crystal clear when a nonprofit board member is faced with a lawsuit alleging improper fiduciary
oversight or improper oversight of employment practices resulting in allegations of sexual harassment or wrongful termination.

Employment-related suits may allege a wide range of wrongful acts, from sexual harassment, to wrongful termination, age discrimination, violation of the Americans with Disabilities Act (ADA), or retaliation for exercising a legal right. The risk of facing an employment-related lawsuit does not necessarily expand proportionately by the number of paid employees in an organization. Often, the parties at odds in a wrongful termination lawsuit are the executive director and the board of directors. Many of these lawsuits can be avoided, or at least be dismissed in the early stages of the lawsuit, if the nonprofit simply follows its own personnel policies. But more on that later...

Other Allegations

More than ninety percent of claims against boards of directors involve some type of employment dispute. While every D&O claim can be costly to defend, the ten percent of claims not involving employment disputes can be among the most expensive claims, and ironically, these often strike the smallest organizations. Another allegation of concern is breach of fiduciary duty. A lawsuit alleging breach of fiduciary duty could be brought by a donor, a concerned citizen, or the Attorney General in your state. This type of lawsuit alleges that the board of directors is not appropriately using and protecting the assets and resources of the nonprofit organization.

There are no laws on the books anywhere in the United States that insulate nonprofits from lawsuits. There are, however, various statutes that are often perceived as offering immunity from litigation. A review of these laws quickly demonstrates why they offer only minimal protection.

State Volunteer Protection Laws

Nearly every state in the country has in place a statute that affords minimal protection to volunteers serving nonprofit
organizations. The intent of these statutes is to enable volunteers to avoid personal liability for simple negligence when they are working under the direction of a nonprofit. Many of these statutes were adopted with the express purpose of encouraging citizens to volunteer their time and service to community-serving nonprofits.

While each state's volunteer protection law differs in some respects, most contain several common features. These include:

- Excluding protection for any willful acts by a volunteer;
- Excluding protection for any claims involving the use of an automobile;
- Excluding protection for any claims alleging violation of civil rights laws;
- Excluding protection for any volunteer serving a nonprofit that does not have liability insurance.

All of these exclusions and exceptions are critically important. First, they represent a significant percentage of the claims filed against nonprofits and nonprofit board members. Claims alleging violation of federal anti-discrimination and other civil rights laws represent a large portion of D&O claims filed against nonprofit volunteers and organizations.

Second, no state law offers protection for allegations of breaches of federal laws, such as those covering racial, sexual and age discrimination and discrimination against those with disabilities. A D&O policy may provide defense for such allegations unless it is determined that the law was willfully broken.

Third, there are no protections under most state volunteer protection laws for directors and officers of nonprofit organizations unless the nonprofit has an insurance policy in place that applies to the claim. So, the catch is, if your nonprofit has D&O insurance, your state law may offer some protection for your volunteers. If your nonprofit doesn't have insurance that covers the claim, forget it. Your volunteers receive no protection under the law.

Fourth, with two exceptions (Virginia and New Jersey), there are no states that provide immunity protection, no matter how minimal, for the nonprofit organization itself. The state volunteer immunity laws discussed here apply only to individual directors and volunteers. A lawsuit against a board of directors will typically name the individual directors and the nonprofit as defendants. Some suits only name the nonprofit and its management.

Finally, while offering limited protection from being found liable by a court, none of the state laws specifically prohibit filing suits against volunteers or nonprofit organizations. Typically, the most expensive part of any lawsuit is the cost of legal defense: determining the facts, such as whether the director or officer acted in good faith, and whether the act was simple or gross negligence. Once the point is reached where the court determines that the board member should not be held liable because he or she acted in good faith and that it was simple negligence, not gross negligence, most expenses of the lawsuit will already have been incurred.

The Volunteer Protection Act of 1997

Federal legislation, known as the Volunteer Protection Act of 1997, was signed into law by President Clinton on June 19, 1997. This law is, in many respects, a mirror image of the state laws that preceded it. In particular, to receive any protection, the volunteer must prove in a court of law that he or she:

- was acting within the scope of his or her responsibilities,
- if appropriate or required, was properly licensed or certified,
- did not cause the harm by willful, criminal, or reckless conduct or gross negligence, and
- did not cause the harm by operating a motor vehicle, vessel, aircraft, etc.

The law also permits states to adopt more stringent requirements, such as the requirement in many states that limit volunteer immunity to cases where the nonprofit organization engaging the volunteer has a liability policy in place to cover the claim.

This law does nothing to protect nonprofit organizations from suits alleging negligent acts by their volunteers. The intent of the law's sponsors was to make certain that if an injury results from the simple negligence of a volunteer, the nonprofit sponsor, not the volunteer, is held accountable to the victim.

"Wait a minute...my board indemnifies board members in its bylaws. Isn't that adequate protection?"

The promise by an organization to indemnify its board members is only as good as the financial resources available to fulfill that promise. When a nonprofit agrees to indemnify board members, it agrees that in situations where it may do so by law, it will pay to defend board members and possibly pay damages.

There are two potential risks here. First, nonprofits may not be permitted to indemnify board members against certain types of actions, such as allegations of self-dealing. For these types of allegations, the nonprofit may be prohibited from using charitable dollars in a board member's defense, whether or not the accusations are justified. Second, few nonprofits have sufficient unrestricted funds or unencumbered cash on hand to mount an expensive and prolonged defense.

Some coverage for board service might be found under an individual's homeowner's policy, but the extent of that coverage depends on the specific wording of that policy. It is not uncommon to find coverage under a homeowner's policy for accidents that cause "bodily injury" resulting in the course of volunteer activities. However, as discussed in an earlier section, insurance policies which cover "negligent acts" rarely cover the "intentional actions" of a board of directors. In a manner similar to a general liability policy, a homeowner's policy may provide coverage for accidents, but these types of policies typically provide no protection for the activities involved in the governance of the nonprofit.

Even if every board member individually has a homeowner's policy that provides coverage for his or her decisions as a board member, these policies provide no protection for the nonprofit itself. In these cases, if the nonprofit is named in a suit it must mount its own defense.

Chapter 3

Claims Against Directors & Officers: Wrongful termination, harassment, and discrimination

While far less common than claims resulting from slip and fall accidents and auto accidents, claims against boards of directors are typically more complex and difficult. A vast majority of claims are lodged by disgruntled former employees and frequently involve a board member or a senior employee with an emotional stake in the outcome and may be reluctant to be completely candid. Often the facts are not clear-cut and are subject to interpretation by the various parties. Getting to the bottom of the issue can be a long, painful and expensive process. In the end, both

parties may feel like losers, no matter what the outcome, because of the financial and emotional expense of the process.

Employment claims against directors and officers of nonprofit corporations typically fall into three major categories: wrongful termination (including retaliation), harassment, and discrimination. Following are sample scenarios to show the reader the types of lawsuits brought against directors and officers, and things to consider to prevent such claims from happening.

Wrongful Termination

An employee of Good Intentions nonprofit complains about illegal business practices and supervisory practices at the organization. The employee is then terminated because of those complaints. The organization insists that the real reason for the termination was poor performance. However, the organization cannot furnish adequate documentation of the employee's poor performance. The jury sympathizes with the employee and concludes that the nonprofit intentionally terminated the employee as retaliation for making waves in the organization.

Firing someone because he or she has pointed out wrong-doing is illegal. If an employee complains about illegal business practices, supervisory practices or any other portion of the business and then is terminated because of those complaints, that employee may well have a valid case for retaliation. Of all employment practice claims, retaliation produces the highest jury verdicts. In most states, plaintiff attorney fees are in addition to the jury award.

If an employee is terminated due to poor performance, even in an "at-will employment" state, the organization should be able to prove in court that the employee was counseled and given ample opportunity to improve his or her performance. Unfortunately, many organizations are lax in compiling and maintaining adequate, appropriate and accurate performance trails. Documentation is key.

Sexual Harassment

A female employee of Tell All nonprofit enters into a romance with her supervisor. One day, the supervisor overhears other employees discussing the relationship between he and the female employee. Feeling that it is in the best interest of his position with the organization, the supervisor breaks off the relationship. The female employee is hurt and angered by the breakup and files a complaint with Human Resources that the supervisor has made unwanted sexual advances at her.

This is a typical sexual harassment case—a romance gone wrong between a supervisor and a person who works for him or her. The organization may be held responsible not only for failing to do something about reported sexual harassment, but failing to investigate allegations of sexual harassment. If an organization fails to investigate sexual harassment charges, they can be held as accountable and as responsible as if the harassment took place with their knowledge and assent.

Discrimination

Save the Land, a nonprofit environmental agency, had applied for a large grant to continue an innovative program for land acquisition and preservation. Unfortunately, they failed to get the grant and were forced to eliminate one of the staff positions serving this program. One of the two positions was held by a 28 year-old man, Tom, who had been working for the nonprofit for 6 years, and the other by a 47 year-old man, Bill, who had been working there for 9 years. After careful consideration, the Executive Director of Save the Land, told Bill he would be terminated in a

month, when the funds were depleted from an earlier grant. The Executive Director's reasons for her decision were Tom's recent college degree achieved during night school and because he was bilingual, which was needed for program delivery. Bill sued for age discrimination.

The claim of age discrimination is not uncommon. Workers over 40, who are passed over for promotions or who lose their jobs when other, younger workers in the same positions keep theirs, frequently respond with a lawsuit. Here, the reasoning of the Executive Director was sound and well-documented and Bill failed with his lawsuit. Another type of discrimination case is based on sexual orientation or identity. The promotion, demotion, etc. was denied because a person is gay, lesbian, transsexual or transgendered. As in all allegations of discrimination, a prompt, thorough investigation into the merits is essential.

Chapter 4

D&O Coverage Forms: Understanding key policy provisions

Unlike general liability insurance, where standardized policy language is amended by specific endorsements, each insurance company writes its own specialized D&O policy. This can make determining what coverage is provided a very difficult process. This is often more complicated for nonprofits because many D&O policies sold to nonprofits contain provisions that initially appeared in traditional for-profit policies.

A wide variety of policies are available on the market today. Your insurance broker can help you evaluate which policy form is best for your organization. There are far too many variables to adequately evaluate the many differences in a booklet of this nature. However, some important distinctions make the coverage provided by some far superior to others. A few of the most desirable provisions of coverage for nonprofits include:

Broad definition of insured

A D&O policy containing a broad definition of "insured" extends coverage to any person who was, is or becomes a director, trustee, officer, employee, committee member, volunteer, intern or student-in-training of the nonprofit and the nonprofit organization itself. This is a major departure from for- profit policies which typically cover only the directors and officers.

To determine whether a particular D&O policy contains this broader coverage, simply look at the definition of "insured."
If the organization and its employees are not named as insureds, the policy offers narrow coverage and the organization and/or its managers are uninsured. Nonprofit managers should ask their insurance professionals to advise them of any potential gaps in coverage of this nature.

Requirement to advance defense costs

Unfortunately, deciphering the language which states how the insurer will pay for defense costs is often difficult. It might be reasonable to assume policy language stating that "the company will pay on behalf of the organization any loss..." is a commitment to pay the costs of legal defense as

they are incurred. However, later in this policy, "loss" is defined as "amount paid by the Insured or Organization." This language, which makes the nonprofit eligible to get reimbursement for defense costs, can be easily overlooked, but it's disastrous to the nonprofit, who is required to reach into its own funds to pay costly legal bills.

Look for the language that requires the insurer to advance the costs of defense. Reimbursement language requires the nonprofit to pay all costs and attorney fees out-of-pocket and wait for repayment by the insurer. Since litigation covered under D&O policies can be expensive and lengthy, reimbursement-style policies can severely stretch a nonprofit's resources.

Broad coverage for employment practices liability

Although increasingly common, employment practices liability coverage is not universally provided in nonprofit D&O policies. In those policies granting coverage, the language is not in a consistent policy section. In some policies, it is found within the section titled "xclusions," where employment contracts are exempt from the breach of contract exclusion. While a policy may indicate previously that claims alleging breach of contract are not covered, under Exclusions there may be a statement indicating this restriction on coverage does not apply to claims alleging breach of an employment contract. In other policies, coverage for employment practices may be found in the body of the policy or in the endorsements.

A broadly written policy covering employment practices should insure a defense for claims alleging a wide range of wrongful employment actions. Some policies accomplish this by extending coverage to employment- related claims while others list the specific causes of action (such as wrongful termination or sexual harassment) that are covered. If the policy includes a specific list, the reader must determine if all exposures are included. There should be coverage for cases arising under both state and federal laws; those specific to employment and those, such as the Americans with Disabilities Act (ADA), applicable in many contexts.

Of equal importance, and not so easily determined, is an insurer's interpretation of certain definitions. If the insurer defines sexual harassment as sexual abuse, there may be no coverage under that D&O policy if it contains a sexual abuse exclusion. If a question is on this matter, a nonprofit manager should ask his or her insurance broker to contact the D&O carrier to determine the insurer's interpretation of this, and similar terms and issues.

Most lawsuits filed against nonprofit directors and officers involve some form of employment practices liability. Insurers are becoming more keenly aware of this exposure and some have made subtle policy changes that restrict coverage in these areas. The nonprofit manager should request his or her insurance professional to make sure that all coverages listed in this section are included in a policy designed to cover the exposures which arise from governance activities, and should check whether a separate deductible applies to employment-related allegations.

Chapter 5

Policies and Procedures: How can you minimize the chances of facing an employment-related lawsuit?

Most employment-related complaints arise from the perception by prospective, current or former employees that an organization failed to treat them fairly or acted illegally. Many potential employment-related claims can be avoided by striving for clarity and consistency in the administration of employment practices.

Every nonprofit's personnel practices should be grounded in legal, defensible practices. In addition, a strong commitment to treat employees fairly and with respect should be the foundation on which all employment actions are taken. The effectiveness of this approach is only as strong as the weakest link in the nonprofit. Therefore, it is crucial that all supervisors and managers be trained and coached in implementing the organization's employment practices. It is not enough to distribute a list or handbook containing the organization's policies. Potential problem scenarios and concerns should be openly discussed. Those who administer employment policies must seek additional assistance or clarification when they do not understand the reasons behind a particular policy or how it should be implemented.

Other strategies a nonprofit should consider in managing the risk of employment-related claims are discussed next.

Keep your employee handbook updated and in compliance with current law

In our review of hundreds of nonprofits' employee handbooks, we have seen policies incorporated into handbooks that are patently illegal. Policies requiring pregnant employees to take a leave of absence, or those requiring employees to work as volunteers instead of receiving pay for overtime work are simply illegal and will be indefensible in a lawsuit. Seek the assistance of an employment attorney to make certain that your handbook is in compliance with your state and federal laws.

Clearly and promptly document each employment action

Each time you meet with an employee for performance counseling, document the discussion and outcomes of the session and have the employee sign it to acknowledge that he or she has seen the document. The employee may disagree with your assessment and may indicate so on the document, however, attempt to have the employee acknowledge receipt and review of the document. Keep one copy in the employee's personnel file.

A decision to terminate employment for performance deficiencies should not surprise the employee. Good documentation, accurate evaluation, and timely discipline will assist you in achieving this goal.

Make "at will" the standard of employment

Unless your nonprofit intends to have relationships with employees governed by contracts, take steps to establish and preserve the "at will" status of your paid staff. "At will" employment simply

means that either the employee or the employer may terminate the employment relationship and for any reason, except an illegal reason. If your employee handbook or other document specifies a term of employment, or provides or suggests that employees will be terminated only "for cause," you have created an additional hurdle for yourself which is not required by law.

Many nonprofit managers resist adopting "at will" language because they believe that they must then become less supportive of employees. The "at will" language does not require employers to terminate without cause, it simply may make it easier to avoid a lawsuit once it is determined that an employee is not performing adequately and must be terminated. (If your nonprofit changes from a policy whereby employees may only be terminated for cause to one where true employment "at will" exists,
it may be necessary to compensate employees accordingly.
Consult an employment attorney for specific guidance on this tricky issue.)

Ban the word "permanent" from your employee handbook

Using the words "permanent employee" in a handbook can create an implied contract of employment. The word "permanent" should not appear in any description of employment or employee status. If you need to distinguish your regular staff from another subgroup you can label them "regular employees."

Do not include termination as one of the actions covered by any grievance policy

To many nonprofits, this recommendation sounds odd. Isn't that often what the grievance policy is for, as an appeals board in case of termination? If you allow a termination to be brought to the grievance committee, you have destroyed your ability to terminate "at will." With the ability to grieve a termination, you may set up your organization to terminate only "for cause" and are creating a procedure you would be require to follow whether the former employee has filed a claim or lawsuit.

Again, this does not mean that your organization should not give ample opportunity to help poorly performing employees improve. It means only that you have reserved the right to determine when termination is appropriate and have not waived that right for some third party's determination of what is proper "cause."
Best practice is to thoroughly review the appropriateness of a termination decision before it is made, not after the fact.

Follow your employee handbook to the letter!

This guideline may be the most important of all. If your policies provide for written notice before termination, if you promise to provide a second chance, if you have agreed to respond in 30 days, etc., do just that. You may take a justified personnel action, however, if you do not follow your own policies, this will be used against you in a court of law. If your policies do not represent your practice, then revise the handbook.

Conduct candid, thorough annual reviews

The key word in the above statement is "candid." If your managers cannot be truthful and candid with employees about poor perfor-mance and areas that need improvement, they should not be

allowed to continue as supervisors. If your nonprofit uses performance as a selection criteria for layoff, yet written performance reviews suggest a consistent record of acceptable performance, a discrimination claim looks much more substantial. Emphasize to supervisors the importance of conducting candid reviews and teach them how to accomplish this goal.

Make a prompt, thorough investigation of allegations of harassment or discrimination

Nonprofit managers are being asked to do more with less and there is never enough time to accomplish it all. However, if you do not take allegations of harassment and discrimination seriously and conduct prompt, thorough investigations, you put your organization and your ability to fulfill your mission at risk. Harassment
and discrimination claims are taken seriously by the courts and allegations of such should be taken seriously. It is also important to remember that any notice of harassment that has occurred, however informal, should trigger an investigation. If an employee approaches a manager and states, "I just overheard Bob making a sexually explicit comment to Marie and she seemed very upset—but I don't want you to actually do anything about it," the manager cannot ignore the comment and should follow the organization's procedure for investigating the matter. All employers must have a written harassment and discrimination complaint policy, even if they have no employee handbook.

Seek legal advice before taking an adverse employment action

Even though your nonprofit may be an "at-will" employer and you can terminate an employee for any reason (except an illegal reason), a court may be sympathetic to a plaintiff terminated under inexplicable circumstances. The very risky nature of terminations warrant consulting an employment specialist before you take adverse action against an employee. Make a commitment to do so every time, with no exceptions.

We understand that with limited discretionary funds, obtaining legal consultation before taking an employment action such as a layoff, termination or demotion, may be a stretch for a nonprofit's budget. ANI and NIAC feel so strongly about the value of such consultation that free pre-termination consultations are avail- able to members who purchase their D&O insurance through ANI or NIAC. For more information about this service, call us at
800-359-6422.

Chapter 6

Board Practices: What board practices are important?

A board of directors should follow several practices to guard itself against the threat of lawsuits. While even the best practices are no guarantee that the board will not be sued, good board practices can be an effective defense with unjustified allegations.

Informed and regular review of financial statements

Board members should understand the sources of income for the nonprofit and know where those resources are being expended. If a professional fundraiser is used, the board should determine that the fee charged by the fundraiser is comparable to that charged for similar services by other companies.

Nonprofits receiving more than $500,000 of federal funds must do annual audits, like many nonprofits under the laws of their state. At least once each year, the audit committee or the entire board should meet with the organization's independent auditor to discuss the audit findings. It is appropriate during the meeting for the board or committee to ask management to leave the room briefly to allow the auditor to speak candidly.

Regular attendance at board meetings

As a board member, ignorance of a problem facing the nonprofit is not a good defense. To render informed decisions about the governance of an organization, board members must thoroughly review background information and attend and participate in board meetings regularly. Board members should also feel comfortable expressing disagreement and voting against proposals for which they are not in favor. Silence may well be interpreted as agreement by a court of law.

Clearly understand the board's role in personnel situations

The chief executive officer of a nonprofit (typically the executive director) should have the authority to hire and fire staff below the executive director level. If the division of labor between the board of directors and the executive director is not clear, the board may find itself embroiled in a situation better resolved at the staff level.

Avoid conflicts of interest

Board members who receive any compensation from the organization must fully disclose the nature of services provided and the compensation received. The board of directors must make a determination, independent of the compensated director, that the arrangement is in the best interests of the nonprofit and that a more favorable arrangement for the nonprofit could not be obtained elsewhere. There are specific guidelines about how these matters must be handled to avoid the possibility of sanctions. A nonprofit uncertain about how this may affect the organization should consult its attorney for specific guidance.

While nonprofits should never make a loan to a director, it is also unwise for a director to make a loan to a nonprofit. A board member with a loan to a nonprofit is in a situation of potential conflict; is he or she acting in the best interests of the nonprofit or in a manner most likely to repay the loan?

Boards with a director who provides insurance or real estate broker services to a nonprofit must be especially careful. While it may appear that that individual is providing the best possible service because of special knowledge and commitment to the organization's mission, the nonprofit should periodically confirm that the services it is receiving are satisfactory and that the cost of the products purchased from the "insider" competes with similar products purchased from other sources.

Enact and Comply with the Governance Policies Required by Law

The federal Sarbanes-Oxley Act, passed in response to corporate accounting scandals, has two provisions applicable to the nonprofit sector. Board members should look carefully at Sarbanes-Oxley and applicable state laws, and maintain all policies required by law and determine whether their organizations ought to voluntarily adopt governance accountability practices, even if not legally mandated.

Under Sarbanes-Oxley, nonprofits must develop, adopt, and disclose a formal policy to respond to employee complaints of illegal, improper or fraudulent activity, and prevent retaliation. Civil rights laws similarly require policies to address complaints of discrimination or harassment of employees. Board members must ensure that the nonprofit thoroughly and promptly investigates employee and volunteer complaints of wrongdoing and implements prompt corrective actions when necessary. This should include a process whereby complaints regarding illegal conduct of the executive director can be made to the board. Sarbanes-Oxley also requires nonprofits to have a written document retention and periodic destruction policy that applies to paper records and electronic files and voicemail.

Chapter 7

In Summary:

Prevention and Protection are the Keys

The majority of boards of directors of 501(c)(3) nonprofit organizations will never have to face a lawsuit. However, no organization should claim that since it hasn't happened in 75 years, it won't occur. The chances of being sued may be modest, but the consequences of an uninsured lawsuit, no matter how unjustified the allegations, can be devaestating.

Recent steep increases in the number of employment-related lawsuits are among the reasons nonprofit board members are at risk. During economic downturns the risk of employment litigation substantially increases as it becomes more difficult for laid off employees to find employment. Employees of nonprofits may be more long-suffering and willing to endure less job security and accept fewer "perks" than their counterparts in the for-profit world. They are probably less likely to sue the nonprofit for whom they have worked hard and in whose mission they believe. However, employees who feel they have been mistreated by a nonprofit or who disagree with policy decisions made by management or the board may retaliate with emotion and conviction. If these disputes result in lawsuits, the process can be expensive and difficult for both sides.

Employee handbooks in compliance with law, with strict adherence to personnel policies, supervisor training, and honest communication with employees can go far to mitigate potential problems. Boards of directors must adopt and stand behind clear anti-discrimination and anti-harassment policies and make sure that management promptly and honestly investigates and thoroughly documents allegations of wrongdoing and takes action. Not all lawsuits can be avoided, but having proper procedures in place and following them can go far toward, providing a strong defense.

Not all D&O insurance policies provide the same protection. A buyer should take care to make sure that the policy includes a broad definition of who is an insured, provides for costs to be paid by the insurer as they are incurred, and includes broad coverage for employment-related activities.

Managing a nonprofit organization is never an easy task and it is getting more complicated each day. Those who volunteer for board membership and those who serve in management positions already give generously their time and their talents. They should not be asked to put their personal assets at risk each time they make a governance decision.