



Directors & Officers  
Liability Loss Prevention  
Guidelines

*for Not-for-Profit Organizations*



**It's Chubb. Or it's Chance.**





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**DIRECTORS & OFFICERS  
LIABILITY LOSS PREVENTION  
GUIDELINES**

**FOR NOT-FOR-PROFIT ORGANIZATIONS**

Prepared by

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Note: The views expressed herein are those of the author and may or may not reflect the views of any member of the Chubb Group of Insurance Companies.

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## **P R E F A C E**

Directors, officers, and trustees of not-for-profit organizations face *personal* liability for their actions as board members. In performing their duties, individuals face greater personal risks than insurance coverage alone can mitigate.

As one of the leading providers of directors and officers (D&O) liability insurance coverage, the Chubb Group of Insurance Companies believes that the long-term solution lies in knowledgeable governance and sound risk management practices.

Chubb commissioned Dan A. Bailey, a member in the law firm of Bailey Cavaleri LLC, to prepare this exclusive D&O liability loss prevention handbook for not-for-profit organizations. This booklet is designed to help those in positions of responsibility protect themselves against litigation arising out of their conduct as trustees or board members. It reviews the general principles governing D&O liability, provides a thorough analysis of many potential exposures, and suggests step-by-step loss prevention procedures.

We believe this brochure offers important guidance and will act as a practical resource for those in positions of responsibility within an organization. It is intended as a general resource to help not-for-profit organizations develop effective loss prevention strategies. It is not a substitute for prudent legal advice. We encourage organizations to seek legal advice from legal counsel for all specific issues that arise as loss prevention procedures are designed and implemented.



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## INTRODUCTION

An effective D&O liability loss prevention program by a not-for-profit organization may accomplish numerous objectives, including:

- Reducing the liability exposure not only of the directors and officers, but also of the organization to the extent the organization may indemnify losses incurred by management.
- Improving the organization's ability to recruit qualified directors and officers.
- Avoiding time-consuming, distracting, and potentially embarrassing claims and litigation.
- Enhancing the defense of claims and reducing the potential recovery by a claimant.
- Improving the organization's ability to obtain favorable D&O liability insurance coverage at reasonable cost.

The material that follows identifies various areas in which D&O liability loss prevention opportunities exist and should be considered. This discussion relates not only to the protection of directors, but also officers, who are held to a similar standard of conduct as directors.

Although some D&O liability loss prevention concepts may seem obvious, many others may be inconsistent with an organization's historical procedures. Management may have difficulty objectively evaluating the necessity and appropriateness of some loss prevention concepts. Accordingly, outside consultants may be useful to assist management in evaluating, structuring, or implementing D&O liability loss prevention programs specifically tailored to the particular organization.

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## MANAGEMENT OF NOT-FOR-PROFIT ORGANIZATIONS

*Not-for-profit organizations should be operated and managed with the same degree of care as for-profit corporations.*

Most not-for-profit organizations have directors with substantial experience and expertise in business matters. Too frequently, however, those individuals abandon their business-like approach to decision making when they sit on the board of the not-for-profit organization.

This practice is contrary to the director's legal and moral duty to act like a business person, using the same degree of commitment, attention, and care as directors of for-profit corporations. Ironically, a not-for-profit directorship is often more demanding than its for-profit counterpart because some of the work will be unfamiliar and the business of the organization may be conducted under less efficient conditions than in for-profit corporations.

Directors should demand that the not-for-profit organization be operated much like a for-profit business enterprise. For example, formal and well-defined operating procedures should be established, strong financial controls and systems should be implemented (including regular preparation of balance sheets and income statements rather than use of mere budgets), and risk management and loss control programs should be adopted.

Not-for-profit directors and officers often ignore prudent business procedures in the mistaken belief that there is minimal, if any, exposure arising out of the mismanagement of a not-for-profit organization. This myth is apparently based on the lack of profit-oriented shareholders in the not-for-profit setting. However, not-for-profit organizations have numerous constituents who may have standing to prosecute mismanagement claims. Every not-for-profit organization is operated for the benefit of some group of persons. Those intended beneficiaries, together with employees, creditors, customers, members, state regulators and others, are all potential plaintiffs. Furthermore, the typical not-for-profit organization has up to *six times* as

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many claims brought against it as does the typical for-profit organization.<sup>1</sup>

Unlike for-profit companies, it is not clear how to measure the performance of many not-for-profit organizations. Directors should devise ways to monitor the organization's financial and nonfinancial performance, particularly in comparison to stated goals. The directors need to resist the temptation to primarily evaluate organization performance by artificial indicators, such as financial budgets. Various nonfinancial criteria can be vitally important to an organization's progress, such as quality improvements, intellectual capital, constituent satisfaction, number of persons served, diversity of services performed, etc. The board should agree on and monitor certain critical metrics to measure the organization's progress and to identify areas that need improvement.

1. Source: *The 2003 Tillinghast D&O Survey Report*, Tillinghast-Towers Perrin.

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## GENERAL PRINCIPLES GOVERNING D&O LIABILITY

*The fundamental responsibility of directors and officers is to prudently represent the interests of the organization's members and other constituencies in directing the business and affairs of the organization within the law.*

In the post-Enron environment, directors and officers of all types of organizations—including not-for-profit organizations—are subject to greater scrutiny. A general sense of skepticism towards the performance and credibility of company officials exists today. As a result, when adverse developments occur, directors and officers are frequently criticized for causing or not preventing the problem.

To counter this climate of distrust, directors and officers need to be particularly vigilant to not only discharge their duties properly, but also to create the appearance of diligent and conscientious behavior. Organizations need to be run with greater transparency so their constituents can have high confidence that there are no hidden improprieties.

### Basic Duties

Directors and officers are subject to three basic duties in performing their responsibilities:

**1. *Duty of diligence.*** Directors and officers 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 business decision, directors and officers must consider all material information reasonably available to them.

This duty requires not only reasonable behavior with respect to matters submitted for approval, but also 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

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are required to implement reasonable programs to promote appropriate organizational conduct and to identify improper conduct.

In some jurisdictions, this duty of diligence may be higher for directors and officers of charitable or other types of not-for-profit entities. The higher standard of care is similar to the high fiduciary duty owed by trustees to beneficiaries of the trust they administer. The justification for this higher standard is the perception that the not-for-profit directors and officers are entrusted with the assets of the organization for the benefit of people who have little or no input into the selection of the directors and officers.

**2. *Duty of loyalty.*** Directors and officers are required to refrain from engaging in personal activities that would injure or take advantage of the organization. They are prohibited from using their positions of trust and confidence to further their private interests. This duty requires undivided and unselfish loyalty to the organization and demands that there be no conflict between one's duty to the organization and self-interest. Examples of prohibited conduct in this regard include:

- Directors and officers may not realize secret profits or unfair gain through personal transactions with or on behalf of the organization.
- Directors and officers may not compete with the organization to its detriment.
- Directors and officers may not usurp an opportunity of the organization.
- Directors and officers may not realize personal gain from the use of the organization's material, nonpublic information.
- Directors and officers should avoid even the appearance of a conflict of interest.

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**3. *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. Directors and officers may be liable if they authorize an act that is beyond the powers conferred upon an organization by its charter or by the laws of the state of incorporation.

Not-for-profit 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, 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 or financial assistance documents.

If the not-for-profit organization is exempt from federal or state income tax or if contributions to it are intended to be tax deductible, a myriad of additional restrictions and requirements may apply. For example, the organization may jeopardize its tax-exempt status if its earnings privately benefit any individual, if it is operated for noncharitable 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. Failure to comply with these technical requirements may subject the directors and officers to personal liability for the damage caused to the organization and perhaps others.

### **Business Judgment Rule**

Directors are presumed to have acted properly and to have satisfied these three basic duties if the Business Judgment Rule (BJR) applies. Recognizing that not all decisions of directors will result in benefit to the organization, the BJR provides directors with a legal defense such that they will be personally liable for loss to the organization only if the elements of the defense are not satisfied.

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To obtain the benefit of this important defense, directors must act in good faith, have a reasonable basis to believe their conduct is in lawful and legitimate furtherance of the organization's purposes, and exercise their honest business judgment after a reasonable investigation.

Five elements of the BJR are generally recognized:

**1. Business decision.** The BJR protects directors from liability in connection with actual business decisions by the directors. Inaction by directors is protected by the BJR only if it is a result of a conscious decision to refrain from acting.

**2. Disinterestedness.** The BJR protects directors who are disinterested and free of any conflicts of interest with respect to the challenged action. For this purpose, disinterested directors are those who neither appear on both sides of the transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing as opposed to a general benefit to the corporation or its constituents.

**3. Due care.** The BJR protects directors if they reached an informed decision after making a reasonable effort to ascertain and consider all relevant information reasonably available to them and after reasonably deliberating the decision.

**4. Good faith.** The BJR protects directors if they acted with a good-faith belief that their business decision was in the best interests of the corporation. The protection will not apply if the directors acted solely or primarily to preserve their positions or otherwise to benefit themselves.

**5. No abuse of discretion.** The BJR protects directors against honest errors of judgment but does not provide protection for decisions that cannot be supported by some rational basis and are egregious on their face.

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## COMPOSITION OF BOARD OF DIRECTORS

*Directors should be selected and retained with a view towards creating the most effective and efficient board possible.*

Too frequently, directors of not-for-profit organizations are selected based on their personal relationships or other contacts, perceived ability to raise or donate money, or visibility in the community. Where possible, the size and composition of the board should be consciously evaluated and determined based

on the organization's unique requirements. Matters that should be considered with respect to the composition of a board of directors include:

**1. Director attributes.** The qualities of an effective director include strength of character, an inquiring and independent mind, practical wisdom, and mature judgment. An ideal director should also have vision, keen insight, imagination, resourcefulness in dealing with unusual situations, and a cooperative attitude. A director should have sufficient time and interest to devote the necessary energies to the required job. Careful scrutiny should be given to the wisdom of selecting a director who is serving on more than three or four boards, particularly if the person also has a full-time job. Persons possessing expertise or experience in different substantive areas affecting the organization may provide greater breadth to the board.

**2. Independent directors.** To be truly effective, a board must be independent from management and not merely rubber-stamp the recommendations of the executive officers. As many directors as possible should be free of perceived impediments to independent thought and action. Prior personal relationships, as well as direct or indirect business, financial, or family connections, between the director and management should be examined. In addition, a candidate's background and other business affiliations should be reviewed to avoid potential conflicts of interest. For example, an independent director should not have an ownership interest in or a management position with a company having substantial dealings with the organization.



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**3. *Size of board.*** Traditionally, boards for not-for-profit organizations have been quite large, frequently exceeding 30 members. It is questionable whether such a large board is the most effective and efficient in fulfilling directorial responsibilities. Detailed and challenging dialogue by all directors is unlikely and quite time consuming with such large boards. Accordingly, smaller boards should be considered, provided diversified and independent representation on the board is not unduly sacrificed.

**4. *Self-evaluation.*** The board should periodically analyze its performance and the performance of individual members. The evaluation of board performance should be performed by members of the board, by management and, where possible, by outside consultants. The evaluation of individual members may be performed by the nominating committee, by all directors anonymously or, where staggered terms are used, by directors not up for reelection. Evaluations should cover such topics as attendance at board and committee meetings, participation in board discussions, contribution of constructive criticism and suggestions, preparedness for meetings, and availability to management.

The evaluations should be reviewed by the nominating committee. If deficiencies are identified, the matter should be discussed personally with the derelict director, giving the person the option of improving performance or resigning. Ultimately, the nominating committee should withhold the names of those persons who are not qualified for reelection based on performance.

To be successful, this evaluation process should be controlled by the directors, the board should embrace the process in a collegial manner, and the results should be confidential within the board. The precise methodology can vary depending on the personalities and unique circumstances of each board, but a few resistant directors should not be allowed to veto the use of an effective evaluation process.

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## EDUCATION

To fulfill their legal responsibilities, directors and officers must have an intimate familiarity with the organization and their legal powers, duties, and restrictions. Because both the factual and legal environment in which the

organization operates and in which directors and officers serve is constantly changing, the need for education is continual.

*An organization should develop a thorough orientation process for new directors and officers and an ongoing commitment to educating them about the particular operations of the organization, the competitive and regulatory environment in which the organization exists, the nature of the industry in which the organization operates, and the legal arena in which the organization conducts its activities and in which the directors and officers serve as fiduciaries.*

**1. Mission of organization.** Unlike for-profit corporations, the basic mission of many not-for-profit organizations may not be intuitive. Therefore, directors and officers must first identify, then periodically evaluate and, where appropriate, revise the fundamental purpose of the organization. A short, concise mission statement, which can then be implemented through interim objectives

and policies, is recommended. Directors and officers should continually seek information about whether the constituents of the organization are obtaining what they want or need from the organization and whether it is time for a change in policy to improve its effectiveness.

**2. Factual orientation.** Formal orientation programs are particularly necessary for new directors and officers. Directors and officers may be personally liable for wrongful conduct regardless of how new they are to their positions. New directors should become familiar with basic corporate records and minutes of recent board and committee meetings; corporate disclosure documents (if available), recent annual reports; board structure and board organization; biographical data of the current board and management personnel; planning documents and studies; management letters from independent auditors; information concerning facilities of the

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organization (including a tour when possible); and information concerning the organization's outlook with respect to current prospects and problems, critical issues, and long-range objectives. Ongoing educational programs should offer insight into current developments in all of these areas.

**3. *Legal orientation.*** The orientation or ongoing education of directors with respect to applicable legal principles must be tailored to the unique set of legal standards relevant to the particular organization and its directors and officers. The standards depend on, among other things, the nature of the company's business, the particular kinds of activities undertaken, the state of the company's incorporation, the locations where it transacts business, the industry in which it competes, and the terms of its articles of incorporation, its bylaws, and other internal documents.

**4. *Training seminars.*** Educational seminars can also enhance board members' skills as directors. Outside consultants are available to conduct seminars intended to develop directorial skills, similar to continuing education programs for other types of professionals.

**5. *Internal guidelines.*** The board should not only educate itself, but also ensure proper education of officers and employees. Among other things, directors should develop, publicize, maintain, and enforce a Code of Conduct and Ethics and other appropriate management policy statements or guidelines defining ethical standards and explaining legal guidelines with respect to various potentially sensitive or misunderstood areas, including:

- Conflicts of interest.
- Antitrust compliance.
- Accounting and financial integrity.
- Payments that may be unlawful or unethical, including bribes and kickbacks.

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- Harassment and discrimination.
  - Political contributions.
  - Confidentiality of corporate information.
  - Misappropriation of corporate assets or opportunity.
  - Whistleblower procedures.

These statements or guidelines should be developed with the assistance of legal experts and should be circulated to all potentially affected personnel. All appropriate employees, including new employees, should sign a statement acknowledging their understanding of the policy and agreeing to abide by it. The organization should periodically review and update these statements or guidelines in view of new legal developments. Any updated material should be redistributed to and recertified by each employee.

Although aggressive implementation and enforcement of these statements and guidelines will not stop determined wrongdoers, it will educate and guide the vast majority of employees on avoiding illegal conduct and may prevent the organization and its management from being charged with wrongdoing, or at least mitigate the severity of sanctions imposed, when a subordinate employee violates the guidelines.

**6. *Compliance programs and internal controls.*** Directors should implement legal compliance programs to detect violations of law, and they should promptly report violations to appropriate public officials and take remedial actions. Although the type and design of such programs will vary among organizations, any program should sufficiently assure the board that the information and reporting systems of the organization are adequate to inform the board in a timely manner of appropriate compliance information. Also, directors should ensure that the organization has adequate internal controls and should receive periodic reports from auditors and others regarding the effectiveness of those controls.

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## ACTIONS BY DIRECTORS

**1. Procedural considerations.** The board should periodically review and agree on various procedural issues relating to board meetings, including the frequency and scheduling of regular board meetings, the timing and content of notice of meetings, and the persons other than directors who should attend the meetings.

*Any action taken by directors must be an informed decision following a thorough, well-documented investigation of all relevant facts reasonably available and applicable by law.*

- a. Board meetings.** Attendance at board meetings is imperative to keep directors informed and to provide the directors with the opportunity for meaningful input into the decision-making process. Accordingly, both regular and special board meetings should be scheduled with a view toward maximizing attendance. Regular meeting dates should be established and communicated to the directors well in advance, preferably at least as a full-year schedule. Special meetings should be scheduled only after the directors have been polled to determine their availability at one of several times, and the directors should be notified of the selected date as early as possible.
- b. Attendance by nondirectors.** Although no one other than the directors has a legal right to attend a board meeting, officers or other key members of management should either be invited to the meeting or instructed to remain available if needed during the meeting. Employees and outside advisors—including lawyers and accountants who have been involved in, are knowledgeable about, or have been consulted in connection with a particular transaction under consideration by the board—should also either attend the meeting or remain available as needed.
- c. Duration of meetings.** Although the quantity of time spent on a particular decision does not necessarily equate to quality of time, it is important to schedule adequate time for directors to completely

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analyze and discuss the matter under consideration. Discussion should not be arbitrarily terminated, and no director should be deprived of an opportunity to question any aspect of the decision.

**2. *Presentation of information.*** Adequate information concerning all important matters requiring board attention should be distributed to the board in time to permit a review of the information before any vote is taken. Procedures should be implemented by the board to ensure that sufficient information is disseminated in a timely manner.

For regular board meetings, a detailed agenda, sufficient background information, and copies of the minutes of all committee meetings and minutes of the previous board meeting should be distributed to the directors approximately one week in advance of the meeting, although less time may be appropriate in rare emergencies. For special meetings, circumstances usually will not permit as much advance notice or planning. However, whenever possible, information should be provided to directors before the meeting, even if expensive courier service is required.

If advance dissemination of information cannot be achieved, adequate time should be set aside at the meeting to permit directors to review and understand the information presented. If for any reason a director has not received sufficient information or time to evaluate the information, action by the board should be delayed until the information is made available in a timely fashion.

The information distributed to directors should include, where available, written reports or memoranda from management that describe the subject transaction and set forth management's recommendations and its reasons for making those recommendations. In addition, copies of the operative documents (e.g., merger agreement, contract, letter of intent, etc.) and executive summaries of the documents, if they are particularly long, complex, or technical; written reports from outside advisors; and proposed resolutions relating to the transaction should also be distributed in advance.

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A director should carefully and critically analyze these documents prior to the board meeting. Directors should plan on devoting a sufficient amount of time preparing for each meeting to become conversant with the matters presented for consideration. A director most effectively contributes to the governance of an organization when he or she engages in debates, exchanges ideas, and suggests alternatives on an informed basis.

**3. *Conduct of meeting.*** Board meetings should be conducted in an unbiased manner. For example, the board chairman should remain neutral as much as possible and encourage open discussion.

It is essential that directors be provided ample opportunity to actively question and challenge management and outside advisors in connection with the transaction. The purpose of the meeting is not so much to act as a single unit but rather to exercise a healthy skepticism toward the proposal and to hear different viewpoints and ideas. Directors should demand and management should facilitate the existence of such an environment. Unchallenged reliance upon management recommendations subjects directors to potential liability.

Inevitably, not all directors will ultimately agree with the board decision. The dissenting director must affirmatively vote against the proposal if a legal defense based upon such dissent is to be established. Mere abstention from the vote is deemed by the courts to be tantamount to approval of the transaction.

**4. *Documentation.*** Maintenance of accurate and complete minutes of all board and committee deliberations and other documents relating to director or officer conduct is one of the most important and most frequently neglected areas of loss prevention. At a minimum, board minutes should document the matters discussed, identify all reports and advice received, record any instructions given to management, and set forth any resolutions passed, actions taken, or other decisions made. Following are some fundamental principles that should be considered when preparing minutes:

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- Minutes should clearly and concisely set forth exactly what action occurred at the meeting, including any limitations placed on the action taken or authority granted and any conscious decision not to act.
  - Minutes should describe what matters were considered and discussed and what authorities were relied on in reaching the decision of the board.
  - If documents are incorporated by reference or attached to the minutes, they should be clearly identified in the minutes themselves.
  - Minutes should be reviewed prior to their finalization not only by the directors but also by legal counsel.
  - Minutes should reflect the results of any vote taken and identify by name all directors who voted against an approved transaction.

Directors should carefully review, not only minutes of meetings that they attend, assuring themselves that the minutes accurately document what transpired at the meeting and their own individual participation, but also the minutes of any meeting that they did not attend. If the absent director dissents or disagrees with actions taken at the meeting, the objections should be placed in writing and submitted to the board for its information and for filing in the organization's minute book.

All documents prepared by or relating to directors and officers should be prepared with the expectation that the document will be closely scrutinized in the future for evidence of wrongdoing. Imprecise wording, inflammatory or vulgar phrases, and ambiguous language should be avoided. A document that appears innocent when prepared may appear quite different when read in a different context at a later date.



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**5. Investigating warning signs.** In most instances, significant organizational problems are preceded by warning signs visible to senior management and directors. Directors should be especially vigilant in looking for and addressing those warning signs. Investigating troubling reports or inconsistent information is vitally important, and directors should demand adequate responses to their inquiries on a timely basis. When a significant problem is identified, the directors should make certain that the board as a whole promptly addresses the problem through a comprehensive investigation and analysis, with candid communications during and after the investigation. If necessary, the board should take decisive action that addresses the matter head-on. Facts and evidence relating to the problem should be preserved for later reference. Specific legal obligations may apply in this regard if an external investigation or a lawsuit is expected or pending. No director or officer should be given special treatment as the board investigates and addresses the problem, and the appearance of any special treatment or consideration should also be avoided.

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## DELEGATION OF RESPONSIBILITY

**1. Board committees.** The use of board committees permits a small number of directors to perform a more in-depth analysis of a particular matter than would otherwise be practicable for the entire board. Use of an executive committee permits emergency action to be authorized between regular board meetings, although the full board should review and, if appropriate, ratify the committee's interim action.

*Although directors may not abrogate their duties, they may rely in good faith on advice or input from board committees, officers, employees, or outside experts.*

An active committee structure should be encouraged, particularly for large boards. The committees should meet regularly, not just when absolutely necessary. Director appointment to the various committees should be considered in view of each director's special talents, experience, or expertise. A formal program of rotating directors among committees may also be advisable.

The board should consider periodically what committees it needs and what functions it wishes to delegate to each. The most common are executive, audit, compensation, and nominating committees. Depending on the organization, other possible board committees include planning, public policy, finance, governance, technology, conflict of interest, and social responsibility committees.

The audit committee is the most important committee from a liability loss prevention standpoint. Audit committee members should actively and regularly analyze the organization's financial statements and discuss a variety of issues with the independent auditors, including the adequacy of the organization's internal controls and accounting systems. The committee must also focus on the qualities and conduct of the independent auditors, and confirm that the auditors have the independence and the professional competence to handle the responsibilities of being the organization's independent auditors.

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**2. *Management delegation.*** Too frequently, boards of not-for-profit organizations become involved in routine corporate operational matters because the organization's staff is incapable or unwilling to assume that responsibility. The board should not engage in direct management of the organization. However, the board has responsibility for monitoring the day-to-day conduct of the organization by ensuring that satisfactory executive management personnel and policies are in place. Essential to the fulfillment of this responsibility is the periodic performance evaluation of executive management, particularly the chief executive officer, and the assurance that clear job descriptions and decision-making procedures are implemented. Officers, in turn, have similar responsibilities with respect to their subordinates.

To avoid having a director, officer, or employee operating outside the scope of his or her duties or neglecting an area of responsibility within the scope of such duties, clearly defined job descriptions should be prepared and disseminated to all management personnel. In addition, authority and responsibility between the board and management should be clearly documented and understood. This is especially true with respect to significant matters in which both directors and management have substantial involvement, such as acquisition evaluations, personnel policies, and major capital expenditures. Similarly defined descriptions of authority and responsibility of the organization's staff and volunteers should be prepared and understood by all involved parties.

Directors should have primary responsibility for instituting a CEO succession plan and management development guidelines. One of the most vulnerable times for a company is when the CEO position is suddenly vacant for an extended period. A preapproved plan by the board that can be easily executed in the event of a crisis can greatly minimize that risk. In addition, such a plan can allow the board to discharge the CEO when necessary without the fear that the organization will be temporarily without effective leadership.

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In addition, the development of talented managers at lower levels is critically important for larger organizations and should be periodically reviewed by the directors. Both succession planning and management development should be a continuous process, designed to reflect the changing needs of the organization.

**3. *Staff selection and overhead controls.*** For many not-for-profit organizations, two of the most important board functions are the selection of staff and the implementation of overhead controls. Most not-for-profit organizations have limited resources and a relatively small number of paid staff members to perform the day-to-day activities of the corporation. Accordingly, it is essential that each staff member be productive, efficient, and needed. Staff compensation and other overhead expenses can easily consume much of an organization's available funds without producing identifiable benefits to constituents of the organization. Directors should closely monitor the use of the organization's limited resources to ensure their efficient and effective deployment and to prevent the organizational mission from simply becoming the continued existence of a meaningless entity.

**4. *Reliance.*** Directors are entitled to the so-called reliance defense, which permits directors to rely in good faith on officers, committees, or agents of the organization when making board decisions. If applicable, the defense establishes that the directors acted in good faith and with due care, although if the law provides for imposition of liability without regard to good faith or due care, the relevance of such reliance may be minimized. Following are the generally recognized elements of a reliance defense:

- a. *Select competent experts.*** A person on whom the directors or officers rely should be reasonably viewed as competent, experienced, and reputable in the area of advice. If the expert has a personal interest in the subject matter of the advice rendered, his or her competence may be compromised. However, if reasonable inquiry by the directors would not have disclosed that conflict of interest, the directors may be able to rely in good faith on the advice given.

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**b. Full disclosure.** Directors may rely on the advice of an expert only if they disclose to the expert all relevant facts known to the directors.

**c. Nature of advice.** The advice relied on must be rendered within the scope of the expert's expertise. For example, if the defense is based on the advice of legal counsel, a legal, nonfactual question should be central to the advice rendered.

**d. Nature of reliance.** Directors must follow the rendered advice in good faith and with due care. The reliance defense is not available if the subject matter of the advice is otherwise clear or unambiguous or the advice is clearly unreasonable or obviously repugnant to the plain facts of the case. Directors have some oversight obligation to become reasonably familiar with the advice before they are entitled to rely on it. Similar principles apply to reliance on officers, committees, or agents of corporations.

**5. Use of legal counsel.** From a liability loss prevention standpoint, perhaps the most important advice to directors is rendered by legal counsel. Counsel should be consulted and used frequently. Qualified counsel can help make board decisions as impregnable as possible. Legal advice not only helps guide directors into legally acceptable conduct but also improves the directors' ability to defend their conduct if their actions are taken in reliance on the legal advice.

Proper use of legal counsel also can serve an important liability loss prevention role for officers. For example, representations and advice by officers or staff concerning the tax, probate, or other legal consequences of contributions to the corporation should be approved by legal counsel. If the organization distributes technical advice or information or publicizes potentially sensitive information, legal counsel should be consulted in advance to ensure that the organization is not unintentionally rendering professional services or disseminating defamatory or other inappropriate material.

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Where possible, directors should only rely on advice provided by qualified counsel with substantial experience and a recognized expertise in the subject area. The board should not feel compelled to use the same counsel for all legal issues but should seek the most competent counsel reasonably available for the issue under consideration.

If a director or officer meets resistance from other members of management in seeking legal advice, the director or officer should persist in the request. Such resistance may suggest that a problem exists that needs the critical review of independent legal counsel.

**6. *Demanding integrity.*** Directors should insist on the highest level of ethical behavior throughout the organization. Directors and senior management should demonstrate a strong commitment to the highest level of legal, moral, and ethical conduct. An organization's culture of integrity is established primarily through the actions of its leaders. Organizations should not tolerate at any level activity that is perceived to be deceptive, manipulative, self-serving, or otherwise improper. One person's illegal conduct can cause enormous harm to a company and expose otherwise innocent directors and officers to potential litigation. A policy of zero-tolerance for questionable behavior should be implemented and enforced at all levels of the organization.

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## CONFLICTS OF INTEREST

Consistent with their duties of loyalty, directors and officers should avoid placing themselves or other representatives of the organization in a situation where their personal interest may, or may appear to, conflict with the best interest of the organization. This restriction applies not only to obvious conflict situations in which an individual is involved in both sides of a transaction but also in more subtle situations. For example, if a director has a close relationship with a person dealing with the organization, the true independence of that director may subsequently be challenged. If an actual or perceived conflict exists, the directors and officers may be required to prove the intrinsic fairness of the challenged transaction to avoid liability.

*Board decisions must be made by disinterested directors. Even the appearance of a conflict of interest should be avoided, if possible, and disclosed if unavoidable.*

Directors and officers should heighten their sensitivity toward conflict issues. Because individuals frequently do not focus on perceived conflicts, frequent inquiries and reminders concerning potential conflict situations are suggested.

Where a potential conflict is identified, the director or officer with the conflict should be removed from the decision-making process if at all possible. For example, a majority of disinterested directors should approve transactions directly affecting employee directors, such as decisions with respect to compensation arrangements and employment contracts. The director with the conflict should not only refrain from voting but also be excused from any board discussions involving the proposed transaction. When that director must unavoidably participate in the corporate decision, full disclosure should be made not only to other people involved in the decision-making process but also to members of the organization, when appropriate.

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A particularly sensitive area of potential liability exposure exists when directors or officers also serve as plan fiduciaries of employee benefit plans for the organization. Such individuals must carefully balance the sometimes competing interests of the organization and plan participants. For example, decisions relating to the timing and method of the organization's funding for the plan present clear conflicts that must be addressed from the standpoint of both the organization and the plan.

In summary, when an actual, perceived, or potential conflict is identified by any person, the following steps should be taken:

- Precisely identify the actual, perceived, or potential conflict.
- Fully disclose the conflict to legal counsel and, where appropriate, to some or all board members together with an evaluation of the effect and seriousness of the conflict.
- Develop an appropriate response, including, where necessary, disqualification from voting and discussion, disclosure to the members of the organization, or other remedial action.

When in doubt as to whether a conflict exists, advice from legal counsel should be obtained.



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## LOSS PREVENTION GUIDELINES FOR SPECIAL RISKS

Following is a summary of loss prevention guidelines with respect to selective, particularly acute D&O liability risks for certain types of not-for-profit organizations.

### Employment-Related Claims

Employment-related claims, including claims for wrongful discharge, discrimination, and defamation, represent one of the fastest growing areas of D&O liability. In fact, almost 9 in 10 claims against not-for-profit organizations are made by their own employees—more than publicly owned and privately held for-profit companies combined.<sup>2</sup> Legislative and judicially established rules in this area are not always intuitive and are sometimes contrary to how many organizations would like to or have historically handled employment-related matters. The Chubb Group of Insurance Companies has published *Employment Practices Liability Loss Prevention Guidelines for Not-for-Profit Organizations*, which is an excellent primer for all directors and officers. A copy can be obtained from your agent or broker or by contacting the Chubb office nearest you.

As a general rule, senior management has two key roles in connection with employment practices liability issues:

- It must set the tone of an enlightened employer by establishing and enforcing guidelines and policies to protect against all forms of discrimination, including harassment, by retaining well-informed human resources professionals and by conducting regular education programs designed to sensitize all supervisors to the rules that govern hiring, firing, and co-existing in today's workplace environment.
- Having set the tone, senior management must personally comply with the established standards and should monitor policy compliance, authorize vigorous investigations where necessary, make accommodations where appropriate, and take meaningful remedial steps, even if senior officers are involved.

2. Source: *The 2003 Tillinghast D&O Survey Report*, Tillinghast-Towers Perrin.

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The most important deterrent to employment claims is a proactive, well-staffed, quality human resources department. The primary responsibility of that department should be to create and maintain legally sufficient and consistent practices with respect to every aspect of the employment relationship. If a not-for-profit organization does not have the sufficient resources to maintain a human resources department, someone within or outside the organization should be designated and trained to fulfill this role.

### **Antitrust Claims**

Antitrust claims against not-for-profit directors and officers are increasing in frequency and can create significant liability exposure for conduct that may appear to be common practice.

Directors and officers who authorize, direct, or participate in a violation of antitrust laws may be personally liable for the violation, even if the individual's involvement was the mere acquiescence or ratification of the activity that is later determined to be illegal. Directors and officers may potentially be liable for the anticompetitive actions of their subordinates if a director or officer discovers unlawful activity by the subordinates and does not repudiate the activity.

Because violators of antitrust law may be subject to treble damages, criminal fines, and imprisonment, methods to minimize personal exposure in this area should be pursued and aggressively enforced. Here are some suggested loss prevention procedures.

**1. *Identify risks.*** Not-for-profit organizations should identify which, if any, areas of their operations are potentially subject to antitrust risks. Once identified, those areas of risk should be communicated to appropriate managers and staff of the organization with specific, well-defined guidelines as to permissible and impermissible conduct in that area. For example, trade associations with numerous members of the same industry should maintain and enforce explicit rules concerning topics and issues that should not be discussed by its members or staff.

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**2. Consult competent counsel.** To evaluate and address antitrust risks, qualified counsel with expertise not only in general antitrust law but also in the unique areas of exposure faced by the organization should be retained and consulted as necessary. The antitrust laws are difficult to apply with certainty to specific factual situations. Subtle provisions in the applicable statutes, rules, or regulations, or in obscure case law that may be directly applicable in the situation in question, can easily be overlooked by legal counsel not intimately familiar with the interpretation and application of these complex laws.

**3. Employ affirmative repudiation.** If a person discovers an actual or a potential antitrust law violation or concludes that continued participation would or may constitute such a violation, the person should immediately and expressly notify the “co-conspirators” in unequivocal terms of the person’s withdrawal from the anticompetitive activity. Consideration should also be given to notifying the perceived victims and perhaps the government of such conduct, as well. A private, uncommunicated decision to withdraw from illegal activity is not effective. When violations are discovered, prompt and unconditional termination of the practice through the most effectively explicit terms is essential.

**4. Be sensitive to risk.** Directors and officers should exercise caution and general common sense when dealing in areas with potential antitrust risk. The antitrust laws are fundamentally intended to eliminate anticompetitive activity. Therefore, when it is impossible or impractical to obtain competent legal advice on a specific legal matter, directors and officers should examine the situation from the standpoint of whether one may perceive a potential anticompetitive result from the proposed activity. Even the appearance of impropriety in this area should be avoided because certain conduct constitutes a “per se” violation of the antitrust laws, regardless of the person’s intent. Particularly sensitive areas include activities with other persons and entities relating to prices for goods and services or allocation of markets.

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## MAXIMIZING LEGAL PROTECTIONS

### Maximize Indemnification Protection

The internal indemnification provisions of the organization should be reviewed in light of applicable state law to ensure that they provide the maximum protection permitted by law. Suggested provisions to maximize indemnification rights include:

*Organizations should take necessary steps to provide a legal environment that maximizes protection to directors and officers.*

- The articles of incorporation or bylaws should provide for indemnification to the full extent permitted by law.
- The provisions should require indemnification, rather than merely permit the organization to indemnify.
- The provisions should require the advancement of defense expenses, subject only to an unsecured obligation to repay the expenses if a court subsequently determines the indemnification was not permitted.
- The provisions may shift the burden of proof to the organization to prove that the director or officer is not entitled to the requested indemnification.
- The provisions may require the organization to reimburse the director or officer for any expense incurred in a claim against the corporation for such indemnification if the director or officer is successful in whole or in part.
- The provisions may provide that the director or officer has a right to an appeal or an independent *de novo* determination as to indemnification entitlement.

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- The provisions may expressly state that the indemnification rights constitute a contract, intended to be retroactive to events occurring prior to its adoption, and shall continue to exist after the rescission or restrictive modification of the provision with respect to events occurring prior to that rescission or modification. Alternately, a separate indemnification contract could be executed by the organization and the director or officer.
  
  - The provisions may provide that any director or officer who serves a subsidiary of the organization or any employee benefit plan of the subsidiary is deemed to be providing that service at the request of the organization.

To avoid any argument that the expanded indemnification protection is unfair, the organization may obtain member approval for the indemnification provision, even if unnecessary under the state law. To ensure adequate funding for any indemnification claim, the organization may secure its indemnification obligation by establishing a reserve fund, providing a guarantee by a related entity, or purchasing a surety bond, letter of credit, or another similar financial instrument.

In addition to maximizing the not-for-profit organization's indemnification provision, consideration should be given to extending indemnification protection afforded by a for-profit corporation to individuals serving at its request as directors and officers of not-for-profit organizations. This outside directorship liability protection is legally permitted in most states and should be specifically mandated by corporate documentation, including documentation that the for-profit corporation expressly requests the individual to undertake the not-for-profit service.

### **Elimination or Limitation of Liability**

Legislation in most states permits the limitation or elimination of certain types of director and, in some instances, officer liability. Many of these statutes require the amendment of the corporation's articles of incorporation

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or bylaws to authorize and define the scope of this liability restriction. The corporation law of the state of incorporation should be reviewed to determine what, if any, affirmative action is required to implement this liability reduction.

For states that require affirmative action, the applicable amendment should limit or eliminate director and, where permitted, officer liability to the full extent permitted by law. The amendment should further provide that any repeal or modification of that provision shall not affect any exemption from liability, limitation of liability, or other right of a director or an officer with respect to any matter occurring prior to the repeal or modification.

Some state statutes permit the elimination or limitation of liability only for directors and officers who are considered “volunteers” and are not compensated. To avoid any suggestion that such a statute is inapplicable, outside directors and other volunteers of not-for-profit corporations subject to such a statute should avoid even the appearance of any compensation by declining expense reimbursements, free meals, and other similar gratuities unless the statute expressly permits such payments.

### **D&O Liability Insurance**

Indemnification by the organization is generally considered, by itself, inadequate protection against D&O liability because, among other reasons, indemnification may not be available for the following reasons:

- The organization may become insolvent or may not have sufficient resources to pay the losses and expenses incurred by the directors and officers.
- Either the applicable law or the corporation’s internal indemnification provisions may be modified to limit or prohibit the expected indemnification.

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- 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 and director and thus does not make the necessary determination to authorize the indemnification.
  - As a matter of policy, the organization may deem it inappropriate to use contributed funds for indemnification.
  - Because of public policy considerations and statutory limitations, some claims may be insurable but not indemnifiable. For example, settlements and judgments in derivative suits are not indemnifiable in many states, and loss arising from violation of the federal securities laws may not be indemnifiable, although such an item may be insured.
  - D&O liability insurance also transfers to the insurer the organization's financial risk of funding its indemnifiable obligation.

As an alternative or supplement to the not-for-profit organization obtaining D&O liability insurance, directors who are also covered by a for-profit D&O liability insurance policy should consider seeking extension of the for-profit coverage to service as a not-for-profit director.

D&O liability insurance is somewhat unique in nature and creates complex legal, underwriting, and management issues that are difficult to identify and analyze without the assistance of knowledgeable experts.

### **Document Retention Program**

To guarantee that valuable documents are not destroyed and that potentially harmful documents are not retained, a document retention program should be established. This program should define the administrative procedures for retaining documents relating to the organization and actions of the board, including financial and legal documents, personnel records, and other files of the organization.

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This program should include procedures for periodic review of documents to determine those that should be retained and those that should be destroyed. Such determination should be made in light of state laws and evidentiary rules that may apply, the degree to which documents are superfluous and unnecessary, and the possibility that the documents may be misconstrued or confusing. When in doubt, the document should be retained.

Such a document retention program should be implemented not only by the organization but also by individual directors and officers with respect to documents in their personal files.

The following key points should be kept in mind when creating and maintaining a records retention policy:

- Policies should be applied uniformly.
- There must be legitimate reasons for the policy and a rationale for the way documents are slated for destruction.
- Policies should take into account any administrative or regulatory record-keeping requirements.
- Policies should not be adopted in bad faith or with the primary purpose to avoid preserving potential evidence.
- If a document is slated for destruction in accordance with company policy at a time when litigation related to the subject of the document is reasonably foreseeable, the document should be preserved. Adequate safeguards should be in place so that an executive or general counsel can quickly notify the department or individual overseeing the records retention policy of the need to preserve records that may otherwise be slated for the shredder.



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## **Legal Audit**

A not-for-profit organization may use a legal audit to inspect and evaluate its legal structure, its pending litigation and potential claims, and its internal policies, procedures, and guidelines with a view to avoiding future D&O claims. Risk management techniques, including indemnification provisions and D&O liability insurance policies, can also be reviewed for scope and adequacy.

In addition to identifying potential problem areas, a legal audit emphasizes to all participants the necessity for compliance with all legal requirements at all times and the importance of preventive planning.

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## ABOUT THE AUTHOR

Dan A. Bailey, Esq., a member of the Columbus, Ohio, law firm Bailey Cavalieri LLC, is one of the nation's foremost experts on matters relating to directors and officers (D&O) liability, litigation, and insurance. He and his firm have represented or served as a consultant to a wide variety of directors and officers, corporations, insurance companies, insurance brokers, and law firms around the country regarding D&O matters.

A frequent speaker at seminars throughout the country regarding D&O liability and insurance, Mr. Bailey is also the coauthor (with William E. Knepper) of *Liability of Corporate Officers and Directors* (7th edition, 2002), and he has written dozens of articles on the subject.

Mr. Bailey received his B.S. degree in business administration *cum laude* from Bowling Green State University in 1975 and was awarded a Juris Doctorate degree with honors from the Ohio State University School of Law in 1978. He is a member of numerous honoraries and was selected for inclusion in *Who's Who in America*.





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