



The liability exposures of nonprofit board members

Are the directors & officers of your organization protected?



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Volunteering to sit on a board of directors for a nonprofit organization is not as simple and straightforward as it used to be. Once thought of simply as an opportunity to make a difference, it has evolved into a position that potentially could threaten an individual's livelihood and personal fortune.

The board of directors of a nonprofit organization can be exposed to a variety of lawsuits, ranging from allegations of wrongful acts to financial mismanagement to errors in judgment and negligence. Claims against directors and officers tend to be costly and disruptive to an organization. Perhaps even worse, if found guilty of misconduct, board members could be personally liable, placing their individual assets at stake. For this reason, directors and officers liability insurance (D&O) is an essential part of any board risk management program, providing financial resources for defense costs and any possible settlement.

The primary objective of a nonprofit board of directors is to provide oversight and direction to the organization so that it can successfully fulfill its mission. Although nonprofit boards are typically not subject to the same level of scrutiny as those in the for-profit sector, they nonetheless owe fiduciary duties to the nonprofit organization and its grantees and donors. Any perceived breach of these fiduciary responsibilities can lead to legal action. A D&O claim can be brought against a nonprofit and its directors and officers for countless reasons; however, a few issues make up a majority of the claims. Some of the more common examples of nonprofit D&O lawsuits are related to grants, fundraising and employment practices.

Grants and fundraising

Nonprofits commonly rely on grants to account for at least part, if not all, of the funding for their annual budgets. Grants are provided by both the government as well as grant-making institutions (foundations). Competition to obtain grant money is always fierce. Questions and concerns about how the funding is being utilized are common and, in some instances, can result in legal action against the grant recipient. Foundations also owe a fiduciary duty to their donors and are subject to lawsuits as well.

When applying for a grant, an organization should proceed with caution and weigh the requirements associated with the funding. Unfortunately, adequate program funding is not always easy to come by, and the pursuit of money can lead an organization into making promises that are both unreasonable and unattainable. If an organization is found to have mismanaged the grant funding and is sued, the repercussions could significantly affect the organization in three ways: legally, through civil litigation or criminal prosecution; publicly, through adverse publicity; and financially, through the revocation of the grant and loss of future funding.

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An example of a lawsuit for misuse of grant funding is the case of the United States vs. Educational Broadcasting Corporation (EBC). EBC received multiple government grants through the National Science Foundation, the National Endowment for the Arts, and the National Endowment for the Humanities from 2001 through 2008. Grant specifications required the funds be used only for expenses that were considered allowable and allocable, and specific documentation of expenses was to be kept. The United States conducted audits and determined that EBC comingled the federal funds with other money and used it to pay for costs not specified by the grant requirements. The United States filed a civil grant fraud lawsuit alleging violations of the False Claims Act. EBC agreed to pay \$950,000 to the United States and to adopt a plan to assure future compliance.

Fraud and financial oversight

Nonprofits, like their for-profit counterparts, are not immune to incidents of fraud. In fact, in recent years it seems that both the government and the media are paying more attention to the administrative activities of nonprofits. A good example of a high-profile incident involves one of the nation's largest charitable organizations, "Feed the Children," and its founder Larry Jones. In January 2011, the Oklahoma Attorney General announced a criminal investigation into the charity during Mr. Jones' tenure. In this instance, nonprofit boards may be held liable for the misuse of grant money if they fail to implement proper controls or provide proper oversight to deter fraud.

An example of a case where board members were sued for failing to provide proper oversight is a suit filed by the California Attorney General against the Monterey County AIDS Project (MCAP). The complaint alleges "mismanagement and neglect of present and former members of its board of directors." It states that its directors, officers and key employees diverted and improperly distributed more than \$2.8 million of charitable assets. The complaint alleges there was a breach of fiduciary duty by the organization and its board for not properly managing and accounting for income received from the "Housing Endowment." According to the complaint, MCAP comingled assets, failed to keep proper expense records, failed to identify improper spending, failed to account for all assets and failed to inquire about the questionable conduct of a few directors and officers.

Not only are grant recipients subject to D&O suits, the foundations that make grants also may be targeted. Foundations are non-governmental organizations created as nonprofit corporations or charitable trusts. They have a primary purpose of providing grants for a variety of different causes. Two types of foundations exist: private foundations that receive money from an individual, a family or a corporation and public foundations that receive support from various sources including individuals, families and government agencies. These nonprofit organizations are also overseen by a board of directors that can be named in D&O lawsuits. Common accusations are by grant recipients for not following through with promised funding or by donors for perceived misappropriation of assets.

Fundraising is an essential source of revenue for many nonprofits. The various ways to raise funds include special events, using the Internet and social media, soliciting endowment gifts, etc. For some organizations, fundraising is its primary source of

revenue and for others it is a way to provide an additional financial boost so it can fulfill its mission and provide for its employees; however, similar to the accountability required as a grant recipient, an organization is also accountable to private donors who want to be sure their donations are being used responsibly.

Entrusted with charitable funds, the board of directors is responsible for developing a budget, establishing financial policies and diligently reviewing information as it pertains to the financial position of the organization. With the proper financial processes and procedures in place, the likelihood of an incident or allegation of fraud will be greatly diminished.

Employment practices

Nonprofit D&O insurance policies typically include insurance protection for employment-related claims. Employment practice liability (EPL) claims are the leading cause of D&O claims against nonprofits and account for a significant portion of the overall liability issues that they face. According to the U.S. Equal Employment Opportunities Commission (EEOC), there were 99,922 total charges of discrimination in the United States in 2010 against for-profit and nonprofit organizations. These are claims of actual and alleged acts of discrimination, harassment, retaliation and wrongful termination.

Since the 1991 amendments to the Civil Rights Act, which gave employees the ability to seek jury trials and punitive damages for mental anguish and emotional distress, employment-related lawsuits have become a serious concern for both for-profit and not-for-profit organizations. With increasingly high costs to defend, settle and pay compensatory awards, the need for EPL protection is especially imperative for cash-strapped organizations and their boards.

The potential high costs associated with employment practice lawsuits can be seen in an example of a nonprofit that terminated an executive for continuous complaints by employees of sexual misconduct and harassment. The executive responded by suing the nonprofit for wrongful termination and the board of directors for interference with contractual relations. After a drawn-out legal process that included multiple appeals, the nonprofit's defense was successful, but the total cost of defending the claim exceeded \$250,000.

Employment practice liability insurance provided by most non-profit D&O policies is a necessity, but it should not be the only defense against EPL suits. Organizational risk management strategies should be in place to help prevent claims from occurring. They should start with the board of directors, who should question the executive director and other managers about employment policies and whether they are being applied consistently and uniformly throughout the organization. The board should establish employment-related policies, develop a system for determining how well the policies are being followed, and identify what actions are being taken to prevent situations where the organization can be potentially liable.

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In closing

The liability risks associated with nonprofit boards are real and ever-changing. At one time, charitable organizations were perceived as the “good guys,” and lawsuits were comparatively uncommon. That situation has changed. Heightened transparency, accountability and a more litigious society mean that nonprofits and their board members are increasingly susceptible to lawsuits. To maintain the health of the organization and security of its board members, every nonprofit should consider a comprehensive D&O insurance policy as part of their overall insurance program.

In the not-so-distant past, it was difficult for many nonprofits to obtain affordable D&O insurance. Fortunately those days are history, and the protection is readily available and accessible. D&O insurance is not a one-size-fits-all product, and the extent of protection can vary based upon the limitations and exclusions listed in the policy. Because of this, the nonprofit and its board should work closely with an agent or broker to assure the proper coverage is provided at a reasonable price. In an industry where every penny can make a difference, the peace of mind that the organization is adequately protected is priceless.

Why Zurich?

Zurich has been providing management solutions for more than two decades – and our Zurich Not-for-Profit Select, built off our current corporate directors & officers (D&O) policy, offers a flexible suite of four coverages created to respond to today’s challenging environment. Coverages include management and entity liability (traditional D&O coverage), employment practices and third party discrimination liability, fiduciary liability and crime. Our comprehensive offering has the flexibility to respond to stand-alone coverage needs or respond as one seamless suite of coverages depending on each organization’s requirements.

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