

Director Liability Protection for Non-profit Organizations

Aon Financial Services Group

Many not-for-profit and charitable organizations (non-profits) are now operated like businesses, with experienced directors and officers, and guidelines for authority and accountability. After a number of scandals in the last decade and with increasing public and regulatory scrutiny, it is clear that the humanitarian, altruistic and volunteer-based nature of non-profits will not insulate their members from the risk of litigation. Non-profits face many liability exposures today, including the risk of personal liability for their directors and officers.

Potential liability

Directors and officers of non-profits share some of the same types of exposures as those who control for-profit businesses, while often receiving little or no compensation compared with their corporate counterparts. Non-profits can be sued or involved in proceedings by a number of parties, including members, third parties and government agencies. Suits may arise from a wide range of causes including:

- Conduct of fundraising activities
- Payment of wages and deduction of taxes for employees
- Breach of statute, e.g. Sarbanes-Oxley, Foreign Corrupt Practices Act and anti-money laundering laws
- Insolvency
- Breaches of fiduciary duty and duty of care
- Negligent supervision, screening or hiring of employees and volunteers
- Additional obligations and higher standards of care as trustees
- Failure to meet requirements for tax-exempt status as a non-profit

Protective measures for non-profit directors and officers

There are a number of measures that directors and officers of non-profits can take to protect themselves from potential liabilities.

Due diligence – The first and perhaps most important is the practice of rigorous due diligence by:

- Fulfilling the duties of good faith and loyalty to the organization and its members
- Avoiding conflicts of interest

- Maintaining confidentiality of board business
- Taking extra care when authorizing and approving budgets and financial disclosure
- Making reasonable efforts to ensure the organization acts lawfully and appropriately
- Adopting internal controls for authorizing transactions and managing assets and costs
- Establishing a written code of ethics for directors of the non-profit; and revising it as needs change

Statutory protection – Some jurisdictions have enacted statutes to protect uncompensated non-profit board members and trustees in certain circumstances. Directors and officers should be aware if they are protected by any such legislation and know the limits of this protection.

Indemnification by the organization – This measure is viable only if the non-profit is financially able to provide compensation. It should also be noted that indemnification may not be appropriate if the directors are acting in a trustee capacity.

D&O liability insurance – Policies can provide coverage for directors for claims arising from their acts, omissions or decisions. Where the organization indemnifies its board, a D&O policy can reimburse the organization for amounts it has paid in indemnification

Conducting a risk review

To determine the appropriateness of indemnification and/or D&O insurance for your not-for-profit, charity, community association or other non-profit organization, it is important to review your operations to determine the potential for board liability. You also need to consider whether policy limits and coverage structure are sufficient to protect personal assets.

Ask your Aon broker for more information and a detailed risk review for your organization.

Non-profit organizations in the crossfire

The following are examples of recent claims that illustrate the broad range of non-profit director and officer liability.

Workplace issues

A non-profit organization failed to investigate an employee's verbal and written complaints of sexual harassment. The organization investigated after the employee quit and threatened to sue. The employee's allegations were discovered to be true, and the harasser was fired. The complainant sued the non-profit and its board of directors for allowing harassment in the workplace, failing to investigate, and constructive termination. The non-profit was also sued by the harasser for wrongful termination.

Misrepresentation, failure to advise

A non-profit housing advocacy group helped twenty families obtain government-subsidized loans to purchase low-income condominiums. Shortly afterwards, real estate prices dropped dramatically and the condos' value was less than the amount of the outstanding loans. The non-profit and its directors were sued by several of the homeowners for misrepresentation and failure to advise of the possible loss of the value of their homes.

Excessive compensation

In 2004, a U.S. state attorney general sued a former stock exchange chairman under state law governing non-profit institutions, to compel the chairman to return the greater part of an "objectively unreasonable" \$190M deferred compensation and pension package. Two and a half years later, the trial court found the chairman had breached his fiduciary duty and ordered him to return almost \$100M. Six months later, the appellate court reversed the decision, dismissing four of the six causes of action. However, it is not known whether any of the parties has appealed.

Fraud, misuse of charitable funds, overstatement of earnings

When a U.S. health education and research foundation filed for bankruptcy in 1998, its six top managers received \$8M in previously deferred benefits; 26 managers were receiving a base pay salary exceeding \$350,000, plus luxury benefits including the use of a corporate jet; and its chairman lived in a foundation-owned mansion and had an annual salary of over \$1M. At the time of bankruptcy, the foundation had laid off employees; was losing \$1M per day in costs and operating losses; and had \$1.2B in debt. Its subsidiaries were responsible for repayment of at least 13 bond issues totaling more than \$900M.

The state attorney general sued for the return of \$79M in charitable assets, ultimately settling for approximately \$20M. The U.S. Securities and Exchange Commission brought civil fraud charges including misuse of charitable funds and overstatement of earnings against the foundation's CFO, two former vice presidents, and three auditors. Criminal charges were also filed against the CFO and the chairman.

Innocent directors

A division of a national safety council suffered financial collapse due to the fraud of the organization's managing director. However, all of the directors (who were acting in a voluntary capacity) were sued by the council's principal creditor. All but one board member settled out of court. The remaining director chose to defend the action and a \$97M judgment was rendered against him. The loss cost the director his personal assets, including his home.

Prepared by:

*Shelley Lloyd, J.D.
Legal and Research Practice
Aon Financial Services Group*

For more information please contact:

National

Brad Lorimer

Senior Vice President, National Director
416.868.2479
brad.lorimer@aon.ca

David A. Griffiths

*Senior Vice President,
National Consulting Director*
416.868.5554
david.griffiths@aon.ca

Ontario

Kimberly Shaw

Vice President
416.868.5642
kimberly.shaw@aon.ca

Québec

Bernard Dupré

Vice President
514.840.7783
bernard.dupre@aon.ca

Prairies

Kathleen Cook

Prairie Region FSG Leader
403.267.7878
kathleen.cook@aon.ca

B.C.

Paul Lively

Senior Vice President
604.443.3353
paul.lively@aon.ca