Directors and Officers Liability Insurance for Nonprofits

Is Your Client Adequately Protected?

By Stephen M. Foxman

When individuals approach an attorney for advice relating to service on a nonprofit board of directors, the careful lawyer will always suggest that the prospective board member check to see if the entity has directors and officers (D&O) insurance coverage for its board members. In this era, with many nonprofits facing financial difficulties, the need for such insurance and the importance of the quality and extent of the coverage are critical issues.

Evolving Fiduciary Duties

Officers and directors of nonprofit boards, like officers and directors of for-profit companies, have fiduciary responsibilities. These responsibilities include the duty of care and the duty of loyalty. Board members of nonprofit institutions may have special fiduciary duties to advance the charitable goals of the institutions and protect their assets. Allegations of wrongful or tortious conduct may require officers and directors to defend themselves from such claims, and to face substantial liability exposure.

Many states have charitable immunity or volunteer protection statutes that protect directors, officers, and trustees of nonprofit corporations or associations. These laws are not uniform. Some states provide immunity for only certain classes of nonprofits, based on type of activity or size. State immunity laws may distinguish between compensated and uncompensated persons, with immunity being available for uncompensated persons only. Some states' immunity laws limit the amount of damages that can be recovered from compensated officers, directors, and trustees, or limit damages based on the type of activity causing the harm or the amount of insurance available to cover the damages. Most immunity statutes do not limit liability for reckless, willful, wanton, or intentional misconduct; gross negligence; knowing violation of criminal laws; motor vehicle liability; or violation of fiduciary duties. In addition, a state immunity law will not shield an officer or director from claims arising from allegations of violation of federal law.

The federal Volunteer Protection Act provides limited immunity for volunteers (of tax-exempt and certain other nonprofit organizations) who do not receive compensation beyond reimbursement of expenses or anything in lieu of compensation valued above $500. The volunteer also must satisfy certain specific requirements to qualify for immunity, and there are certain statutory exclusions where immunity does not apply. The Volunteer Protection Act preempts state laws to the extent that such laws are inconsistent with the act, but states may enact additional protections or opt out of the act's coverage.

Although state and federal immunity statutes may protect officers and directors, such statutes do not provide for the cost of defense, and, as noted above, the immunity may not be available because of statutory exceptions. If immunity is not available, officers and directors will be forced to seek indemnification for liabilities and costs under indemnification provisions of statutes and entity governing instruments, or specific contracts. Such indemnification rights, however, are subject to limitations and restrictions, and they are only as good as the economic viability of the entity.

Board members (and depending on state law, possibly officers as well) may be able to avoid liability by invoking the business judgment rule. The business judgment rule provides that board members acting in good faith, and with the rational belief that their actions are in the best interests of the entity that they serve, are protected from liability for erroneous judgments. Although there is not much case law regarding the business judgment rule's applicability to nonprofit board members, it is generally believed that nonprofit board members have the same right to rely on the business judgment rule as for-profit board members, although the scope of the rule may be somewhat different because of the mission responsibilities of nonprofit board members. Some states have incorporated the business

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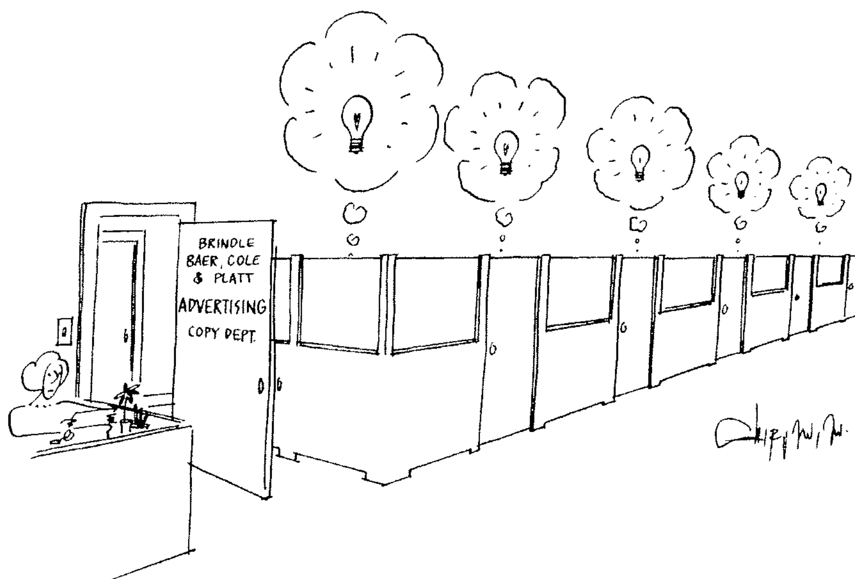
judgment rule, or something conceptually close to it, into a statutory basis for a claim of immunity from liability under the states' immunity laws.

The standards imposed on officers and directors with respect to the duty of care have tightened in recent years. Historically, board members did not have an affirmative responsibility to discover or investigate facts upon which they might rely in making decisions. More recent court decisions in Delaware have imposed a duty to be informed—to affirmatively investigate facts in order to determine that a reasonable basis exists for accepting such facts. If officers and directors are on inquiry that facts might not be as they were presented, the courts have held that they have a duty to inquire further to determine the validity of such facts.

In addition to the duty to be informed, the courts have imposed a duty on officers and directors to implement and monitor a system of oversight, in order to ensure that their institutions are being properly managed and operated. The Delaware chancery court, in the famous *Caremark* case, held that directors there did not breach their fiduciary duties, but described the standard of care imposed on directors as follows: ". . . a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards." *In re Caremark Int'l*, 698 A.2d 959, 970 (Del. Ch. 1996).

In a recent Delaware chancery court case, the court stated that "a plaintiff can show bad faith conduct by, for example, properly alleging particularized facts that show that a director consciously disregarded an obligation to be reasonably informed about the business and its risks or consciously disregarded the duty to monitor and oversee the business." *In re Citigroup Inc. S'holder Derivative Litig.*, 2009 Del. Ch. LEXIS 25, 40–41 (Del. Ch. Feb. 24, 2009).

Although a thorough analysis of nonprofit board members' fiduciary duties and the applicability of the business judgment rule to their conduct is beyond the scope of this article, the effect of this evolution of board member fiduciary duties has been to increase the liability exposure of directors and officers serving both nonprofit and for-profit institutions. In the for-profit world, this increased liability exposure may be offset to some extent by the fact that officers and directors are compensated for accepting such risks, and usually have access to sophisticated counsel. The nonprofit world is often less fortunate. Many nonprofits do not have the ability to compensate officers and directors, compensation when paid is usually lower than that in the for-profit world, and access to counsel for advice may be much more limited.



If indemnification or immunity is not available, officers and directors must look to D&O insurance. In the event of any suits or claims against them, they can turn to the insurer to provide a defense, and bear any liability that ultimately may be assessed. The cost of such insurance, however, may be a significant burden for many nonprofit entities.

Types of D&O Insurance Coverage

There are three types of D&O insurance coverage. The first type is Insuring Agreement A coverage (A-Side coverage), which covers the right of directors and officers to receive direct payment from the insurer for defense costs and liability if they are sued, if they do not have a right to be indemnified, or indemnification is not available because of insolvency. The second type of coverage is Insuring Agreement B coverage (B-Side coverage), which covers the institution or entity regarding reimbursement for amounts advanced to satisfy indemnification claims that the directors and officers may make against the institution or entity under corporate law or the organizing documents of the institution or entity. The third type, Insuring Agreement C coverage (C-Side coverage), often referred to as entity coverage, provides insurance for the entity itself for its own wrongful acts, typically to cover securities claims, and to avoid an allocation of benefits between the company and the officers and directors. Insurers may provide one or more of the above types of coverage.

Insureds may obtain primary and excess coverage. These multiple layers of insurance provide a tower of insurance protection for the insureds, and provide a higher aggregate limit

of coverage. However, as described below, such coverages may interact and conflict with each other in ways that may not have been anticipated, and excess coverage may not apply until the primary and other senior-level policies have been exhausted, despite the existence of gaps in coverage at one or more senior policy levels.

Exhaustion of Policy Limits

High policy limits are costly, and based on the current deep downward turn in the economy and the probability of an increase in claims against companies in many market segments, it is likely that insurance premiums charged for coverage will increase substantially. Lower policy limits may not be a good answer to this. Even before reaching the question of the adequacy of policy limits to satisfy any ultimate liability for a judgment or settlement, defense costs alone may exhaust the policy limits. Under the provisions of most D&O policies, the insured chooses its own counsel, and, accordingly, the carriers have less control over the cost of defense than when the carriers appoint counsel to defend the insured.

I recently became aware of an action against a nonprofit entity and its officers and directors filed about five years ago. Defense costs exhausted the policy limits, and the court handling the case recently entered a substantial judgment against the entity and the directors and officers, jointly and severally, and there are no remaining D&O insurance proceeds to pay this judgment if it survives appeal.

Loss of Insurance—Failure to Notify

As most lawyers are well aware, notice of a claim must be timely given to the insurer. These notice provisions often require notice as soon as the insured becomes aware of facts that make it likely that a claim may occur.

Usually, an insurer denying coverage based on late notice has to show that the late notice actually caused the insurer some prejudice, but it is preferable for the insured to avoid this issue by providing early notice of the claim or risk of claims. Where timely notice is a condition precedent to coverage, late notice, even without prejudice to the insurer, may cause the loss of coverage.

Other policies covering (for example) employment claims, theft losses, and advertising also may be involved, depending on the facts and the nature of the claims made, and care should be taken to notify all carriers where coverage may apply.

Exclusions

Knowledge Exclusion. A common exclusion from coverage is that the insured had knowledge of facts and circumstances at the time of policy inception that might reasonably be expected to result in a claim.

Under the provisions of most D&O policies, the insured chooses its own counsel.

This exclusion may have particular significance where an officer or director of a nonprofit wears two hats, and is or was affiliated with outside entities that dealt with the nonprofit entity defending the claim. If an officer or director had access to information through other business relationships, this special knowledge could trigger the knowledge exclusion in the D&O insurance policy, and may be imputed to other officers and directors.

The imputation of knowledge to the other officers and directors depends on the severability language of the relevant policies. Severability may exist at either the application level or the exclusion level. Each insured may have represented in a separate application that he or she did not have knowledge of any facts or circumstances that might reasonably be expected to result in a claim. If the application form is silent regarding imputation, this suggests that knowledge would not be imputed to all from the knowledge of any one applicant. The language of the exclusion itself, in the policy, may specifically impute knowledge of any individual insured to all insureds, or may be silent on this subject. This leads to an interesting interplay between the severability language of the application and the effect this may have on interpretation of severability under the exclusion language of the policy.

Entities frequently have both primary and excess D&O policies, and the applicability and interpretation of severability language may be impacted by the way the primary and excess policies interrelate or the manner in which excess policies may incorporate terms of the primary policy. Many excess policies have "follow form" provisions that adopt the terms of underlying policies, which may impact severability and applicability of exclusions. Another issue arising out of multiple layers of insurance is whether or not coverage gaps caused by the knowledge exclusion in one policy will impact coverage provided by other excess insurers (e.g., the excess insurer's coverage may provide that it is only applicable after the senior level policy's coverage is exhausted).

The fact that the knowledge exclusion may exclude coverage for one claim does not mean necessarily that other claims in the same proceeding are excluded from coverage. The insured may be able to assert that he or she is entitled to a defense and coverage as to one of a number of claims, even though one or more other claims would not be covered because of the knowledge exclusion. A determination must be made to what extent claims made against the officers and directors arise out of known facts (implicating the knowledge exclusion in the policy), or arise out of other facts that may not have been known, and whether coverage will be denied as to one set of claims but not as to others.

Personal Profit and Fraud Exclusions; Rescission for Misrepresentation. D&O

insurers usually exclude coverage for claims arising out of circumstances where the actor is seeking to obtain a personal profit. The personal profit exclusion will exclude coverage for a loss that arises out of an insured having gained an economic advantage to which the insured was not entitled, if such a finding is part of an adjudication. This may arise where an officer or director acted both for his or her own entity and for another entity at the same time. The exclusion does not prevent the officer or director from seeking coverage and being reimbursed for defense costs, but it may ultimately prevent the officer or director from having liability coverage if there is a determination that the officer or director directly or indirectly received an economic benefit, where such benefit is alleged to have been improper.

D&O policies also do not cover fraud, dishonesty, or criminal or intentional misconduct by an officer or director. Typically, these exclusions only apply once there has been an adjudication of such misconduct. Adjudication may occur in the context of the underlying litigation giving rise to the claim, or it may be an adjudication brought about by an insurer's litigation to determine coverage. The insurer, however, may not be able to bring such a proceeding unless the policy itself specifically provides for such a separate proceeding to determine whether the misconduct occurred.

As discussed above, the severability language of any applicable D&O policies will be critical in situations involving one or a few bad apples. If one officer or director is a participant in knowing wrongful conduct, will this be imputed to all other officers and directors? Many D&O policies specifically provide for nonimputation—but many do not. In cases where imputation is permitted, the quick guilty plea by one of the bad apples could prevent the other officers and directors from being able to get defense costs after this "adjudication" occurs.

Policy rescission is an extraordinary remedy that an insurer may seek in circumstances where the insured has misrepresented material facts on the insurance application, or in the course of providing information upon which the insurer relied in issuing the policy. As noted above, the severability language in the application may be critical to a determination of whether the misrepresentation of one officer or director will be imputed to all officers and directors.

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Insured Versus Insured Exclusion; Bankruptcy Issues. D&O policies may contain an exclusion that denies coverage if one insured sues another insured. This exclusion prevents an officer or director (and other persons or entities who fit within the definition of "insured," which may include employees and former officers and directors) from being able to look to the policy if claims arise in the context of litigation between or among insured persons or entities, including claims between the institution and its own officers and directors. To get around this exclusion, insureds may negotiate endorsement carve-backs to provide coverage for derivative claims, employee practices claims, and claims by a bankruptcy trustee, or a receiver or liquidator.

Where a nonprofit entity seeks bankruptcy protection, the trustee in bankruptcy (or a receiver or liquidator) and others may make claims against the officers and directors, which would implicate the insured versus insured exclusion. As noted above, this is sometimes dealt with by an endorsement to the D&O policy that provides a "bankruptcy trustee carve-back," which avoids loss of coverage because of the insured versus insured exclusion.

Bankruptcy also raises the issue as to whether the proceeds of the D&O policies are property of the bankrupt's estate under 11 U.S.C. § 541(a)(1). The trustee or debtor in possession, creditors, and other claimants will want such proceeds to be property of the estate so that the proceeds may be used to pay expenses and satisfy claims. If the proceeds are property of the estate, then any action by the directors and officers to seek payment of defense costs or to satisfy any liability that may be imposed is likely to be resisted based on the effect of the bankruptcy automatic stay.

The law is not clear on whether D&O proceeds are property of the bankrupt's estate. Trustees will use the existence of B-Side coverage for indemnification obligations, and C-Side entity coverage to argue that such proceeds are intended to benefit the debtor, and that to the extent that the monies are paid to the directors and officers, this will necessarily reduce the value of the asset otherwise available for the debtor. In some cases, courts have held that

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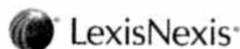

A-Side coverage payable directly to the officers and directors is not property of the estate. In other cases, courts have held that the debtor's right to be reimbursed from insurance proceeds for indemnification obligations or under entity coverage is not property of the estate because the right to recover is hypothetical (i.e., the right to indemnification is likely to be in dispute, and will not be resolved until the ultimate determination of liability for claims asserted against the officers and directors, and entity coverage generally does not come into play because securities claims against the debtor are stayed).

The existence of C-Side entity coverage may create a problem for officers and directors because this coverage is intended to benefit the debtor directly. Where such coverage exists, the argument can be made that the proceeds of such coverage are property of the estate and that all proceeds of all the D&O coverages should be drawn in to become property of the estate because the combined coverages are subject to a dollar limit, so that any payment of direct costs and liabilities of officers and directors by necessity will reduce the amounts available for the debtor and its creditors under the entity coverage.

If a court determines that the proceeds are property of the estate, the directors and officers affected may still request that the automatic stay be lifted so that they may receive payment under the policies. Another possible point of contention is the ability of the directors and officers to utilize D&O policy proceeds to settle litigation against them, thereby removing all or a portion of the available insurance proceeds that otherwise would be available to a trustee or creditors.

To get around the problem posed by assertion that D&O insurance proceeds are property of the debtor's estate, insurers may allow the insured to designate priority of payment, so that any insurance proceeds are to be used first for A-Side coverage, then for B-Side coverage, and, finally, for entity coverage. This should strengthen the argument that the proceeds are not property of the bankruptcy estate. The insurer and insureds also contractually may agree to a prepetition waiver and release of any automatic stay, but this may not be enforceable.

For a more in-depth discussion of some of these issues, see Kimberly M. Melvin, "D&O Policy Proceeds as Bankruptcy Estate Assets: The Elusive Quest for Clarity," Coverage 16, no. 3 (May/June 2006) (a publication of the American Bar Association, Section on Litigation, Committee on Insurance Coverage Litigation).

Another approach would be to cause the institution or entity to purchase a separate A-Side coverage policy, an individual director liability policy, or a Side A/DIC (Difference in Conditions) policy with dedicated limits to the individual director, to provide coverage directly to the officers and directors where indemnification is not available because of the financial distress of the institution or entity, or coverage is otherwise not available. The Side A/DIC policy is usually written as an excess policy to the Insuring Agreement A, B, and C coverages, but it will drop down and become primary coverage if the underlying insurance does not provide coverage. It can avoid loss of coverage, and fill in gaps in coverage, based on claims of rescission (the DIC policy can be nonrescindable), pollution exclusion, insured versus insured exclusion arising out of claims of a bankruptcy trustee or related to defense costs, ERISA exclusion, rightful or wrongful refusal to indemnify under a presumptive indemnification clause, fraud (as to defense costs or certain securities claims), narrower exclusions in underlying policies of D&O insurance, or loss of underlying insurance coverage for any reason.

Other Exclusions. The inadequate consideration exclusion allows the insurer to avoid being required to supplement consideration paid in connection with a merger and acquisition transaction. Once the transaction is closed, claims may be made that an acquirer paid too much or too little for the acquired assets or company.

The creditor exclusion, if present in a D&O policy, may deny coverage for any claims by creditors against the debtor entity or the insured.

The securities exclusion may preclude coverage if the claim is based upon, arises out of, or results from an actual or alleged violation of the securities laws, or specifically designated securities laws.

Conclusion

From the above discussion, it is evident that those individuals who have accepted the role of serving as a director or officer of a nonprofit entity, and who have relied on the existence of D&O insurance coverage for protection, may not have the level of protection that they anticipated, or reasonably should require.

The practitioner, when asked for advice by a current or prospective officer or director, not only should advise the client of the need for an adequate level of D&O insurance coverage, but also should request a copy of the policies, and analyze those policies. As noted above, there are many pitfalls for the unwary insured, and the insured's counsel. The D&O insurance should provide coverage in amounts sufficient to cover both defense costs and liability exposure, and the practitioner should attempt to have exclusions deleted or limited (or endorsement carve-backs added), and separate A-Side coverage, or A-Side/DIC coverage, written for the benefit of the officer or director client. BLT