



DIRECTORS AND OFFICERS INSURANCE

Some have often asked questions regarding D&O Insurance:

- Should a nonprofit organization carry Directors & Officers Insurance?
- Are lawsuits against Boards a serious problem?
- Do volunteer protection laws eliminate the need for D&O Insurance?
- What does a D&O policy cover?
- What are common D&O policy exclusions?
- Defense costs-covered or not?
- What if board members have their own insurance?

Should a nonprofit organization carry directors and officers insurance?

Few liability insurance questions arise more frequently or are harder to answer than whether to buy D&O insurance. The general lack of clear answers results in many D&O purchasing decisions being based on misunderstandings about board liability and the scope of D&O policies. To provide a better basis for decision-making, this article draws upon the knowledge and expertise of insurance experts, lawyers, board members, and nonprofit organization managers.

Because circumstances vary so much across the country, this article cannot provide universal recommendations. Instead it supplies some tools for each board to use in making its own decisions.

Following common practice, this article uses the term “D&O insurance” to refer to a category of insurance policies that protect board members from certain types of suits. Other policy features, including coverage for the organization itself and coverage for D&O claims against individuals other than directors and officers vary. As article explains, the differences among these coverage’s may be critical to deciding whether to buy D&O insurance.

As useful as this article may be, it cannot substitute for the assistance of legal and insurance professionals who specialize in this field.

Some facts about D&O suits against nonprofit are apparent.

- Claims are less frequent than for general liability.
- Unless they engage in serious misconduct or self dealing, extremely few volunteer directors have been personally liable.
- Claims are almost always settled without going to trial.
- Defense costs, even in successfully defended cases, tend to be very high.
- The suits are usually brought against the organization itself, regardless of whether individual board members are named.
- The majority of claims (although not necessarily the most costly ones) arise out of the employment process:
 - Discrimination

- Wrongful termination, and
- Harassment.

In assessing the likelihood of a claim, the essential starting point is the legal basis for suits that D&O policies cover. One advantage of incorporating a nonprofit organization is to protect board members from personal liability for harm caused by other people acting on the organizations behalf. Individual liability results only from board member's own actions or failures to act in accord with his or her board duties. In those instances the errant board member as well as the organization may be held liable.

Every primer on board responsibilities emphasizes their principal legal duties of board service: care, loyalty, and obedience (which is sometimes included as part of the duty of care). Failure to satisfy these duties can lead to a lawsuit if the error causes harm and an injured person is able to sue.

Do volunteer protection laws eliminate the need for D&O insurance?

Every state now has at least one law pertaining specifically to legal liability of nonprofit organization directors. Although the proponents of these volunteer protection laws may have wanted to shield directors from personal liability unless they intentionally hurt someone, few of the resulting laws provide that much protection.

Each of the volunteer protection laws modifies the legal standard for determining whether directors are legally liable for harm their actions cause. In place of the ordinary standard for judging directors' conduct, the volunteer protection statutes substitute gross negligence, recklessness, willful and wanton misconduct, or some other less exacting standard. Unless directors' conduct fails to satisfy whatever standard the law specifies, they cannot be held personally liable.

Enactment of these laws has had little effect on the cost of D&O insurance for the following reasons.

- The protection applies only to volunteers' personal liability; the liability of the organization itself is not affected.
- The laws do not limit liability under federal statutes, including civil rights, labor, and tax provisions.
- Claims can still be filed, requiring a legal defense and imposing associated costs regardless of who wins.
- The new standards, particularly gross negligence, may not significantly reduce liability in practice.
- The constitutionality of the laws has not been tested (although in most states the possibility of invalidation is slight).
- Lack of uniformity across states undermines statistical assessment of the laws' effects on claims.
- In the future, proponents of greater volunteer protection may amend or replace the existing laws.

What does a D&O policy cover?

Directors and officers insurance policies are designed for a variety of claims alleging harm attributable to the governance or management of an organization.

Unfortunately, D&O policies are not standardized and tend to be complex. The discussion here highlights the principal features.

One universal characteristic of traditional D&O policies is that they do not list specific types of claims covered. Instead they extend coverage for any “wrongful act,” which is very broadly defined. The scope of that coverage is then narrowed by a list of limitations and exclusions.

Gaps In Coverage

Several characteristics of most D&O policies create potential gaps or deficiencies that must be checked. Caution is urged in this area because D&O insurance differs in so many respects from other types of coverage that ordinary assumptions about how insurance works may be entirely erroneous. As explained below, the treatment of any of the following items may produce a coverage gap or reduce the value of a policy.

- Incidents that occur before the policy is in effect
- Claims that occur after the end of the policy term
- Explicit exclusions
- Definitions of key terms, e.g., “wrongful act,” “claim,” “loss,” that constrict coverage
- Reimbursement of expenses rather than payment as incurred
- Deduction of legal defense costs from the maximum amount the policy will pay for a claim
- Defense costs for excluded claims

Common D&O Policy Exclusions

If one had only five minutes to read a D&O policy, the time would be well spent examining the list of exclusion.

Bodily injury (General Liability) Property damage (General Liability) Professional services (Malpractice)
Handling Funds (Fidelity, Bond) Nuclear radiation, pollution damage Illegal acts
Dishonest acts Intentional misconduct Punitive damages

Common D&O Policy Exclusions

Fines, penalties and matters uninsurable by law
Failure to obtain adequate insurance
Contract claims
Employee retirement income security act
(ERISA) Antitrust, price-fixing, restraint of
trade
Peer review,
standard setting
Credentialing,
certification
Discrimination
Sexual misconduct
“Insured versus
insured”
Injunctions/no
pecuniary suits

One exclusion with potentially unrecognized adverse consequences for a nonprofit organization is generally phrased as the “insured versus insured” exclusion. This exclusion is designed to eliminate coverage for struggles over control of the organization, which can be intractable. Not all insured versus insured claims fit this mold, however. If the executive director is covered under the policy, his or her wrongful termination claim against the board member would be excluded. Any “insured versus insured” exclusion must be examined to determine how it applies to employment related claims.

What if board members have their own insurance?

Few liability insurance policies that individuals purchase primarily for other purposes will protect them against a D&O claim. At one time many homeowner’s policies and personal umbrella policies included such coverage. Now, the protection is rarely available and, if so, usually costs extra. Far more people believe that because their personal liability insurance policies do not list “board service” among the exclusions, they have adequate protection. The flaw in this reasoning has to do with the scope of coverage under these policies.

Personal insurance policies are very specific in terms of what they cover. The implications of this point are clearest for an auto insurance policy. A board member’s auto policy ordinarily will cover claims from accidents that occur in the course of board service. It will not cover claims for breach of a director’s duties to the organization.

Thus, the terms of a personal insurance policy’s coverage are critical even if the policy explicitly encompasses board service. Many homeowners’ policies apply only to claims based on bodily injury, property damage, and a few other specific types of harm. That coverage is not likely to apply to wrongful termination, discrimination, misuse of funds, or defamation (libel or slander) claims.

As a final note, the D&O insurance policies of some business corporation and nonprofits cover their executives for volunteer board service elsewhere. This feature is usually added as a special endorsement and may be available only for individuals who serve on a board at their employer’s request. Moreover, most business corporations’ policies have a high deductible.

The above information is meant to provide you with a very broad overview of what coverage’s D&O policies provide and why there is the need for this coverage in nonprofit organizations.

This information was part of a handbook published by the Nonprofits’ Risk Management and Insurance Institute and if you would like a copy of the complete handbook, contact your state office.