

# Doing the Right Thing

*Your public expects you  
to be 'ethical,' but that  
isn't always easy*

**By Lisa Soronen**

If you want to get rich and famous, perhaps school board membership is not the right path to take. But, getting “famous” via school board membership may be easier than you think. After receiving a few wary looks when I made this statement at a gathering of new school board members, I offered a recent front-page story from my hometown newspaper as proof: “City Council Members Violate Open Meetings Act.” There it was—local, elected public officials who were famous (albeit just in my small hometown) for meeting at a local restaurant and discussing council business without notifying the public or making the “meeting” open to them. When school board members, like city council members, violate ethics requirements, community members understandably get upset, and board members and their violations appear in the local newspaper. School board members have been chosen by their peers to represent the public in making choices about the community’s most precious resource, so they have little room to err. Being ethical is not as easy as it sounds, however, for two important reasons.

## **What Is Ethical and Fair?**

First, it is not always clear what is ethical and what is unethical. Sometimes ethical requirements are specified in statutes, and sometimes ethical questions are answered in case law or in opinions by the state attorney general. But it is unlikely that even these combined sources will contemplate every ethical question a board member might have. Likewise, even if your ethical question has been addressed by some source of law in your jurisdiction, it is likely that the law does not provide a clear answer. For example, a Michigan statute states that a school district may pay the “actual and necessary expenses incurred by its members and employees in the discharge of official duties or in the performance of functions approved by the board.” The statute goes on to say that reimbursement must be approved before the expense is incurred and the expense must be consistent with a policy adopted by the board specifying categories of expenses. What the statute does not say is what categories boards cannot or should not reimburse or what specific dollar amount in each category can or should be reimbursed.

A second reason is that sometimes ethical requirements simply don’t seem fair— or, perhaps more accurately, the concerns the requirements address do not seem to apply to the situation at hand. For example, a newly elected board member became shocked and upset when I explained to him that he could no longer coach football for the district because of the doctrine of incompatible offices. (That is, the board member could not be both the master and the servant of the district.) He replied that he had played football as a student in the district years ago and had coached for years in the district. To help him make sense of this ethical requirement, I asked him to envision this scenario: The

superintendent thinks the football coach/board member should be terminated from coaching because of a lack of skill or some other reason. Consider how awkward it would be for the superintendent to tell this to “the boss” (that is, the board member) and how awkward it would be for the football coach/board member to vote on the status of his own job. While the new board member could see my point, at least theoretically, he still had a hard time seeing how it applied to him, considering his years of successful coaching for the district.

### **Staying Ethical**

So, given these challenges, what can school board members do to remain ethical?

I recommend taking the following steps:

#### **1. Learn the ethical requirements of your state.**

Find out what topics are covered by the sources of ethics law in your state. Then learn the “black letter law” and familiarize yourself with the “gray areas” also. Determine the reasoning behind ethical requirements so that if you have to make a decision about a gray area, you’ll understand the spirit of the law.

#### **2. Determine where to go for help.**

Many ethical dilemmas have no clear answers, so find some people you trust who can help you work through ethical challenges. For example, your board may consult legal counsel employed by the state school boards association, or you may ask for advice from your district’s legal counsel. In some states, you may also be able to ask a state ethics board or the attorney general for an opinion about a specific ethical question.

#### **3. Consider the outcome.**

When a clear answer is not forthcoming, ask yourself, “If the local media found out I did X, would a story about it appear in the newspaper?” When there is no statute, case, or attorney general opinion addressing a particular ethical issue, a board member will not be tried in a judicial court or an ethical breach but may be tried in the court of public opinion. Ultimately, when pondering unclear ethical dilemmas, it’s important to make choices that are in line with the values of the community you represent. Of course, this is not easy. Reasonable minds may disagree on what is right, and community members may lack the information and experience to judge board members’ decisions fairly. For example, it may be difficult for a small-town board member to convince community members that spending \$25 for lunch in San Francisco while attending the NSBA annual conference was reasonable, given the city’s high cost of living and the need to select a restaurant near the convention hall so the board member would be back in time for the next session.

# **Risk Management Pool Accountabilities, Responsibilities and Liabilities: The Tennessee Case Study**

## **I. Introduction**

A recent highly publicized audit report by the Tennessee Comptroller of the Treasury stated that a former executive director of the Tennessee School Boards Association ("TSBA") and current director of the Tennessee School Boards Risk Management Trust ("TSBRMT") paid over \$400,000 in unauthorized fees and commissions to the manager of the Trust. TSBRMT writes insurance policies for schools and local governmental entities around the state. The audit also revealed that TSBRMT faces losses of \$10.2 million over a four year period. The TSBRMT manager allegedly kept custody of \$6.7 million in premiums for several months, earning interest of at least \$59,000 that was never turned over to the Trust. Additionally, the audit revealed that the former executive director authorized the payment of over \$250,000 in pension benefits to himself prior to his retirement.

The Tennessee audit report brought to light issues regarding lack of oversight and scrutiny by the Board of Directors for TSBRMT and TSBA. The audit specifically alleges that the Board allowed its executive director to operate with little or no oversight. The audit further claims the Board was misled when it approved the payment, and faults the board for not getting any advice from outside attorneys or accountants.

Numerous highly publicized private business and nonprofit corporate scandals in recent years have revealed cases in which board members, through lack of oversight, knew little about the organization's financial arrangements. Additionally, these examples have pointed out some potential ethical and legal pitfalls that could plague an organization if staff members are not acutely aware of the financial dealings of the organization. As the TSBRMT case illustrates, conflict of interest and other liability issues can arise for both staff and board members of public risk sharing nonprofit organizations. Today's topic will examine potential liability of nonprofit staff and board members and how public risk sharing organizations can defend and protect itself from exposure.

## **II. Corporate Governance of Public Risk Management Pools**

Public entity risk sharing pools are corporations established to benefit local governments needing insurance and risk management services. Most jurisdictions treat public risk management agencies as public entities rather than insurers and the municipalities like members of a reinsurance pool rather than normal insureds. Such programs allow local public entities to pool their liability risks. Generally, the programs encompass defense and indemnity against public tort liability and workers' compensation coverage for public entity members.

Public risk management pools are generally incorporated as "public benefit" or "mutual benefit" nonprofit organizations. The governing power resides in a board of directors composed of representatives from member entities, such as cities or counties. The board may elect a member executive committee from among its members to which it gives authority to make and implement any

decisions, including those involving administration. If an executive committee is formed, the board retains the power to review, modify, or override any decision or action of the executive committee. Public entities are the “members” of the pool whose position is similar to that of shareholders in for-profit organizations. The directors of a nonprofit organization stand in a fiduciary relationship to the members. However, the staff of a nonprofit organization carries out the day-to-day activities.

A commonly held myth associated with nonprofit exposure is that there are few sources of claims since nonprofits do not have shareholders. While it is true that the vast majority of lawsuits against nonprofits are filed by current and former employees (alleging wrongful employment practices), nonprofits serve large and varied constituencies to which their boards and staff owe specific fiduciary duties similar to the duties owed by corporations. These constituencies are potential plaintiffs in legal actions brought against nonprofits. Potential claimants in a suit against nonprofits include:

**Insiders**—The current and former staff of a nonprofit may bring actions alleging a host of wrongful acts, including wrongful termination, discrimination, sexual harassment, and Americans with Disabilities Act violations.

**Outsiders**—Third parties that have a relationship with the nonprofit may allege harm caused by the nonprofit and/or its directors, officers, or staff. Outside sources can be vendors, funders, or another nonprofit.

**The Entity**—The nonprofit organization may bring an action against its directors and officers. Examples include claims by current management against a former trustee. In most states, derivative suits are permitted. In a derivative suit, members of a nonprofit may bring a claim on the nonprofit’s behalf against a director and officer. (Note: Claims by the entity against its directors and officers will likely be excluded under most nonprofit Directors’ and Officers’ insurance policies).

**Directors**—A nonprofit director may sue another board member alleging violation of a duty owed to the nonprofit. Under certain circumstances, such an action may be compelled.

**Beneficiaries**—The people you are in business to help - your service recipients - may bring claims against directors and officers alleging wrongdoing.

**Members**—Directors and officers of membership associations are vulnerable to claims brought by members alleging harm to the interests of the member.

**Donors**—A nonprofit's contributors may sue directors and officers alleging misuse of a restricted gift.

**State Attorney General**—In most states, the state attorney general represents the interests of the general public in assuring the proper management of public benefit corporations like public risk management pools. As such, the Attorney General may bring a claim against nonprofit directors and officers alleging wrongdoing.

**Other Government Officials**—Other government officials, including representatives of the U.S. Internal Revenue Service and the U.S. Department of Labor, may bring actions against nonprofit directors alleging violation of state or federal laws.

**A. Fiduciary Duties of Nonprofit Directors and Their Impact on Risk Management Pool Staff**

Historically, nonprofit organizations were organized as trusts, and the trustees managing the affairs of the organization were held to a strict standard of care. As nonprofits gradually came to be organized as corporations, legislatures and courts replaced trustee precepts with corporate governance principles and now apply the corporate standard of care to nonprofit directors. However, most information on which decisions are made by the is provided by the staff of the organization.

Common law and statutory schemes recognize two fiduciary duties on the part of nonprofit directors: the duty of care and the duty of loyalty. Failure to satisfy either duty can lead to a lawsuit.

**1. Duty of care**

A director's duty of care is the obligation to exercise ordinary prudence - to investigate and to deliberate adequately - in making business judgments for the corporation or its members. The standard of care is statutorily defined in every jurisdiction. Most states have adopted language similar or identical to section 8.30 of the Revised Model Nonprofit Corporation Act:

(a) A director shall discharge his or her duties as a director, including his or her duties as a member of a committee:

- (1) in good faith;
- (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner the director reasonably believes to be in the best interests of the corporation.

This reasonable person standard applies to the director's duty of care not only in decision making, but also in oversight, involving the ongoing monitoring of the corporation's affairs. Thus, the duty of care is implicated in cases of director mismanagement, neglect, improper (but disinterested) decision making, and failure to comply with the corporation's internal laws. Oversight failures by disinterested board members, such as those alleged by the Tennessee audit against the TSBMT board, must be scrutinized under a duty of care analysis. (Note that most jurisdictions, including Tennessee, allow directors to rely upon certain experts, such as attorneys and accountants, in performing their duties in good faith as long as such reliance is reasonable). A director who acts in compliance with the above standards will not be liable for a breach of the duty of care.

**(a) Business Judgment Rule**

Although most state nonprofit laws do not expressly refer to the business judgment rule, many courts nonetheless apply the rule when reviewing decisions of nonprofit directors. The business judgment rule has application as a potential defense for directors in two situations: (1) where directors face personal liability; and (2) where the corporation (generally through members in a derivative action) seeks to void a decision of or transaction approved by the board. Summers v. Cherokee Children & Family Services, 112 S.W.3d 486, 529 (Tenn. Ct. App. 2002).

The business judgment rule forecloses a court from inquiring into the decisions of corporate actors, so long as their decisions are *disinterested* and made in *good faith* with *due deliberation*. It should be noted that good faith could be implicated if the directors do not exhibit sufficient oversight to the staff to demonstrate reasonable reliance. A person challenging such decisions has the heavy burden of showing lack of faith and due deliberation.

The purpose of the business judgment rule is to allow officers and directors to take legitimate business risks without subjecting their decision making to judicial scrutiny. When a director fails to possess disinterested status in his decision making, the business judgment rule will not provide protection.

Note that the business judgment rule is applicable only to allegations of breach of the duty of care. When a breach of the duty of loyalty is alleged, the business judgment rule provides no protection. Note also that the business judgment rule applies only to business *decisions* and is not applicable to oversight issues or in cases of nonfeasance.

## **2. Duty of Loyalty**

The duty of loyalty mandates that directors refrain from self-dealing. The duty of loyalty is generally defined as the obligation to give primacy to the interests of the corporation rather than personal concerns - to avoid self-dealing at the corporation's expense. In a nonprofit public risk management corporation, a director's duty of loyalty lies in pursuing or ensuring pursuit of public or mutual benefit which is the mission of the corporation. Similarly, the nonprofit's staff is charged with the same duty.

The legal definition of conflicts of interest is also set out specifically in each state's nonprofit laws. In Tennessee, a conflict of interest transaction for a nonprofit director is statutorily defined as "a transaction with the corporation in which a director or officer of the corporation has a direct or indirect interest." Tenn. Code Ann. § 48-58-302(a). A director or officer has such an interest if "another entity in which the director or officer has a material interest . . . is a party to the transaction" or "another entity of which the director or officer is a director, officer, or trustee is a party to the transaction." Tenn. Code Ann. § 48-58-302(c).

Under the Revised Model Nonprofit Corporation Act, any conflict of interest transaction is voidable by the corporation, and may be the basis for liability of a director or officer, unless the transaction was fair at the time it was entered into or is approved in accordance to statutory provisions. Summers, 112 S.W.3d at 504-505; Tenn. Code Ann. § 48-58-302(a). Under Tennessee law, a conflict of interest transaction may be approved if:

- (1) The material facts of the transaction and the director's or officer's interest were disclosed or known to the board of directors or a committee consisting entirely of members of the board of directors and the board of directors or such committee authorized, approved, or ratified the transaction;

(2) The material facts of the transaction and the director's or officer's interest were disclosed or known to the members and they authorized, approved, or ratified the transaction; or

(3) Approval is obtained from:

(A) The attorney general and reporter; or

(B) A court of record having equity jurisdiction in an action in which the attorney general and reporter is joined as a party.

Tenn. Code Ann. § 48-58-302(b). Any approval by the board requires the affirmative vote of a majority of the directors who have no direct or indirect interest in the transaction, but no such transaction may be approved by a single member of the board. Tenn. Code Ann. § 48-58-302(d). (Note that if ratification occurs, the court will review the board's approval action under duty of care analysis and the business judgment rule and not the duty of loyalty). Approval meeting the statutory requirements simply removes the voidability of the transaction by the corporation, or personal liability for directors and officers. Directors considering such approval must comply with their fiduciary duties in deciding whether to approve. Summers, 112 S.W.3d at 505.

When director decisions are tainted by a personal conflict of interest, the director's actions are subject to analysis under the duty of loyalty, which does not provide for business judgment rule protection. Thus, courts will not review under the business judgment rule a board's enactment of a compensation plan in which a directors has a personal interest, such as the pension plan authorized by Dr. Tollett in the TSB RMT example discussed above. In this type of self-dealing situation, the courts require the board to prove good faith and fair and adequate consideration. If the payment fails such scrutiny, it constitutes corporate waste.

Clearly, the most egregious cases of director misconduct in the nonprofit context usually involve some sort of self-dealing or conflict of interest that would constitute a violation of the duty of loyalty. Consider, for example, the recent case of Miniace v. Pacific Maritime Assoc., 2006 U.S. Dist. LEXIS 6842 (N.D. Cal. Feb. 23, 2006). Pacific Maritime Association ("PMA") is a nonprofit mutual benefit corporation governed by a Board of Directors that consists of senior executive officers from its member companies. Miniace, who served as president, was terminated when the Board discovered that Miniace and McMahon (PMA's chief financial officer), both staff members as well as directors, received benefits which had not been formally disclosed to the Board. While serving as president, Miniace

implemented a "Secured Executive Benefit Plan" ("SEBP") to provide retirement benefits to executives. After McMahon was diagnosed with terminal cancer, Miniace and McMahon, without full disclosure to the other board members, executed amendments to the SEBP policy allowing McMahon's beneficiary, and not the employer, to receive the bulk of the policy's death benefits. At the direction of PMA, Miniace and McMahon also served as two of the three board members of a for-profit subsidiary of PMA. At a board meeting at which they were the only directors present, Miniace and McMahon voted to pay the subsidiary's directors a substantial bonus fee for attending board meetings.

PMA brought claims for unjust enrichment and breach of fiduciary duty against Miniace. The court held that Miniace owed a duty of loyalty to the PMA board which included a duty of candor. Miniace's duty obliged him to inform PMA of the duties he performed within the scope of his employment. By failing to inform PMA of the director's fee, Miniace effectively increased his salary without disclosing it to the board, thus violating his duty of loyalty to PMA. The court also found that Miniace's duty of loyalty prevented him from engaging in self-dealing transactions at the expense of PMA. A fiduciary's dealings must ultimately be for the benefit of the corporation. By awarding himself a director's fee from PMA's subsidiary, Miniace received a benefit and unjustly retained it at the expense of PMA.

PMA also brought a claim against McMahon's successor in interest for breach of fiduciary duty regarding the amounts received under the SEBP policy. The court scrutinized McMahon's conflicts of interest in amending the policy and held that a director (who is both a fiduciary and interested party) must not become involved in a transaction or decision from which he might personally benefit, and where his personal interest might conflict with the interest of the corporation. In participating in the decision to amend the policy, McMahon failed to live up to his duty of loyalty to PMA.

Note that the situation at PMA bears striking similarities to activities of Dr. Tollett as alleged in the Tennessee audit report.

Other situations may invoke scrutiny under the duty of loyalty analysis, such as:

- a. Corporate opportunity doctrine: If a director discovers an opportunity in his capacity as a director, he must give the corporation the opportunity to take advantage of the deal instead of hiding the opportunity from the corporation and taking advantage of it himself. A director violates the duty of loyalty if he "usurps" a corporate opportunity. See Tennessee Dressed Beef v. Hall, 519 S.W.2d 805 (Tenn. App. 1974). In order for there to be a usurpation:

(I) The opportunity must be the type the corporation might reasonably be expected to take an interest; and

(ii) The corporation must be financially able to take the opportunity.

These opportunities arise frequently in the nonprofit context. While doing business for the corporation, the director can easily encounter an opportunity that he can take advantage of without the corporation knowing.

Example: A specific example might be an opportunity for the corporation to participate in a fundraising event. If a nonprofit public risk management director, for example, hears of this in his capacity as director but takes personal advantage of the opportunity or takes advantage on behalf of another corporation with which he is associated, he has violated the duty of loyalty.

b. Improper use of corporate property or information: A director violates the duty of loyalty by divulging the corporation's financial strategy or giving out names of people who donated to the corporation so another corporation might solicit from the same people.

While the above-mentioned duties arise in the director context, one can see how staff mismanagement or intentional misconduct could subject the organization to potential liability.

## **B. Types of claims against nonprofit board members for breach of fiduciary duties**

When director misconduct occurs, causes of action against individual board members may include the following:

### **Direct Suits**

Generally, the state attorney general, an officer or director, the entity itself, a receiver, trustee in bankruptcy, or a judgment creditor all have standing to bring a direct action for misconduct against a director. Some states also allow for "special interest" standing, i.e., parties with special interests such as donors and beneficiaries. Directors may be held personally liable for breach of fiduciary duty and any tortious injury personally caused by them.

Pursuant to Tenn. Code Ann. § 48-58-110(a)(1), the Attorney General may bring an action to remove a director of a nonprofit corporation who is "engaged in fraudulent or dishonest conduct or gross abuse of authority or discretion, with respect to the corporation."

### **Derivative Suits**

The responsibility of enforcing nonprofit law generally rests with the state attorney general, whose task is to protect the public interest. Historically, a

member who suspected that a nonprofit director had breached a fiduciary duty to the corporation must either have prevailed on the directors to bring an action on behalf of the corporation or brought his complaint to the Attorney General's attention. Now courts in most jurisdictions recognize the right of members to bring derivative suits on behalf of "public benefit" and "mutual benefit" nonprofit organizations. Even before the adoption of the Revised Model Nonprofit Corporation Act, Tennessee recognized the right of members of a nonprofit corporation to bring the equivalent of a shareholder derivative action against the directors and officers for wasting corporate assets and using corporate assets for personal gain. Bourne v. Williams, 633 S.W.2d 469 (Tenn. Ct. App. 1981). The Bourne court found that Tennessee had long recognized the right of aggrieved shareholders to sue for the benefit of the corporation to rectify a wrong to the corporation, and "that members of nonprofit corporations have the same rights in this regard as stockholders of corporations for profit." Bourne, 633 S.W.2d at 471-472.

In a derivative suit, a member sues the director not on his own rights, but on behalf of the corporation. The member is the nominal plaintiff and the corporation is the real party in interest. Again, it is not hard to envision situations where the negligence or intentional misconduct by the staff at Risk Management Pools could expose the organization or individual directors to liability.

### **Criminal Penalties**

In cases involving particularly egregious conduct or specific statutory violations, law enforcement agencies may bring criminal actions against directors of nonprofit corporations.

### **Piercing the Corporate Veil**

A number of jurisdictions allow an aggrieved party to apply the remedy of "piercing" to nonprofit entities. "Piercing" is an equitable remedy developed by courts to hold individuals responsible for acts commissioned by a corporation. Courts will only pierce in the unusual circumstance: to prevent fraud, achieve equity, or avert the violation of a statute or public policy. Under the "piercing" doctrine, courts may hold liable corporate actors who misuse the corporate form in such a manner as to accomplish their own personal affairs rather than that of the business of the corporation.

The piercing remedy compensates for the losses incurred by the misconduct of directors. Under the "piercing doctrine," a plaintiff can attack the director's personal assets. Note, however, that a corporate officer is personally liable for torts he personally commits regardless of piercing of the corporate veil.

### **C. Directors' and Officers' Insurance**

Most states allow for directors' and officers' (D&O) insurance to protect directors from paying judgments out-of-pocket. D&O insurance typically consists of two separate parts: one reimburses the corporation for any indemnification payments it makes to directors and officers, and the second provides for direct payments to directors and officers when they are not reimbursed by the corporation.

Typically, D&O policies for nonprofit corporations cover the "wrongful acts" that occur in the insured's capacity as an officer or director. The term "wrongful acts" usually means any breach of the duty of care, error, neglect, omission or act committed solely in the course of the activities of the organization. Insurance statutes usually do not cover duty of loyalty violations, but do cover duty of care violations.

### **D. Volunteer Protection Statutes**

The federal Volunteer Protection Act ("VPA"), adopted in 1997, establishes a minimum level of protection to nonprofit volunteers that preempts state law, except to the extent that state laws provide greater protection. See 42 U.S.C. § 14501, *et seq.* The VPA limits liability for harm caused by acts or omissions done within the scope of responsibility on behalf of the organization, except where the harm was "caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a flagrant indifference to the rights or safety of the individual harmed." 42 U.S.C. § 14503. Under the VPA, punitive damages may not be awarded against a volunteer unless the above-referenced exception applies.

The VPA specifically protects a volunteer who:

- (1) performs services (including directors, officers, trustees and direct service volunteers);
- (2) volunteers for a nonprofit organization or governmental entity; and
- (3) either (a) receives no compensation (although reasonable reimbursement for expenses is allowed), or (b) does not receive anything of value in lieu of compensation in excess of \$500 per year.

Thus, directors for nonprofit organizations who do not meet these conditions enjoy no protection under the VPA. The VPA does not affect the liability of the nonprofit corporation and governmental entities with respect to harm caused by volunteer action. Moreover, the VPA does not preclude actions against volunteers brought by the nonprofit corporation itself.

Every state has a law that pertains specifically to legal liability of some volunteers. Most state volunteer protection laws protect directors or officers serving nonprofit boards

by limiting liability as described in Section III(A) above. See, e.g., Tenn. Code Ann. § 48-58-601.

#### **IV. Protecting the Public Entity Risk Management Pool Board**

The Nonprofit Risk Management Center released a resource on nonprofit directors' and officers' liability insurance entitled D&O: What You Need to Know. The new publication discusses the role of Director and Officer coverage in an overall risk management program aimed at governance risks. An excerpt from this new publication follows:

##### **Pursue a Multi-Faceted Strategy**

As community-serving nonprofits grow and many assume responsibility for social services previously delivered by governments, the need for committed, enthusiastic, and capable volunteer board members has never been greater. While claims against nonprofit boards remain rare - most nonprofits will never be sued in their institutional lifetimes - the fear of liability continues to grow. This fear is fueled, in part, by widespread publicity surrounding celebrated cases. This publicity in turn leads to more claims. Nonprofit and corporate directors share a common concern: that of personal liability for serving on a board. At the end of litigation against nonprofits, nonprofit board members are rarely required to use personal funds to pay for harm committed by the board or organization, but the possibility remains. Some party or the nonprofit itself may charge the director with a breach of duty that he or she owed to that party.

Every nonprofit must work diligently to recruit and retain suitable board leaders. One strategy is to address the potential for personal liability by taking steps that substantially reduce the likelihood that a board member's personal assets will be exposed to loss. We suggest a three-part protection strategy for nonprofit boards as described below:

**1. Risk Control** - Every nonprofit should begin the process of reducing the potential of a director being held personally responsible by minimizing the risk. This effort begins with examining the board's governance activities, and the common law duties owed by each and every board member. Do board members fully understand their legal duties? Do board operations reflect a commitment to fulfill these duties? What actions are taken when a breach of a fiduciary duty is suspected? Has the board established rules and procedures governing its operations? Are these procedures followed?

The process of identifying priority risks and implementing strategies to address them should continue with all major operational areas. Form a volunteer risk management committee to coordinate the process of risk identification and strategy development.

Even the smallest nonprofit can and should establish a risk management committee. In smaller nonprofits volunteers will hold most of the seats on the committee, while in a midsize or large nonprofit the committee may consist principally of paid staff. The nonprofit should focus first on high priority risks - those most likely to occur and those with the greatest financial and other adverse impact on the organization.

**2. Indemnification & Volunteer Protection** - Most nonprofit bylaws include indemnification provisions - language that expresses the intent of the nonprofit to cover the expenses a board member might incur in defending an action and paying settlements or judgments related to his service on the board. There are circumstances, however, when indemnification is not available or becomes a hollow promise. These include:

When the nonprofit does not have sufficient resources to pay the losses and expenses incurred by a director or officer;

When state or federal law limits the protection that may be afforded through indemnification due to public policy considerations;

When the board is unsympathetic to the plight of the director who has been sued and refuses to authorize the indemnification;

When the organization decides that it is inappropriate to use the nonprofit's financial resources to indemnify a director.

Every state has a volunteer protection law and the federal Volunteer Protection Act (VPA) became the law of the land in September 1997. The Volunteer Protection Act provides that, if a volunteer meets certain criteria, he or she shall not be liable for simple negligence while acting on behalf of a nonprofit or governmental organization. The VPA also provides some limitations on the assessment of noneconomic losses and punitive damages against a volunteer. The Volunteer Protection Act does not, however, protect a volunteer from liability for harm "caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer action." The Act does not prohibit lawsuits against volunteers nor does it provide any protection for nonprofits.

The state volunteer liability laws vary significantly. Some states only protect directors and officers while other states extend the protection to all volunteers, however, every volunteer protection statute has exceptions. The most common exclusions are for claims based on a volunteer's willful or wanton misconduct, criminal acts, or self-dealing.

**3. Risk Financing** - Every nonprofit must consider how it will pay for injuries, damages, legal expenses and other costs that stem from the harm it causes. For some organizations, reserve funds are sufficient to pay for anticipated losses. For the majority of the nation's 1.5 million nonprofits, reserves are inadequate. For this reason, a growing number of nonprofits choose to purchase insurance and pay an annual premium in exchange for the promise that funds will be available in the event a covered loss occurs.