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On the Frontlines

Laws, Not Lawyers

How states can protect nonprofit leaders and infuse more money into
the sector

By John H. Vogel Jr., Sarah Gohl Isabel, & James Sears Bryant

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Laws, Not Lawyers

How states can protect nonprofit leaders and infuse more money into the sector

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On an average day, newly formed nonprofit organizations in the United States need to recruit at least 1,000 volunteers to serve on their boards of directors. Our analysis of Internal Revenue Service data also shows that existing nonprofit organizations must recruit at least the same number each day to replace their retiring directors.

To protect these board members, many nonprofit organizations purchase directors and officers (D&O) liability insurance. The median annual D&O premium is less than \$4,000, according to a recent Tillinghast survey of 479 nonprofit organizations. Nonprofits may consider a mere \$4,000 a reasonable cost of doing business.

But if we add up the cost of D&O insurance for the 317,689 501(c)(3) organizations that filed IRS Form 990 in 2004, we estimate that D&O insurance drains more than \$1 billion from the nonprofit sector every year. Two-thirds of that money is used to cover legal fees and related expenses. In other words, most of this money ends up in the pockets of lawyers.

Despite its high cost, D&O insurance does not adequately protect nonprofit board members. The insurance policies generally do not protect directors whose actions are alleged to

be “grossly negligent” or “wanton and willful” – ambiguous labels that creative lawyers have little trouble applying.

Were the trustees of the University of Pennsylvania, New York University, and Syracuse University grossly negligent when they allowed their financial aid officers to establish revenue-sharing agreements with a preferred lender, which benefited their universities? Did they even know about these arrangements? As is often the case when a state attorney general threatens to sue trustees, these universities did not contest the allegations and instead settled the lawsuit out of court.

D&O insurance policies also vary significantly in the types of acts they cover, sometimes insuring “wrongful acts” such as neglect or breach of duty and other times excluding such acts. These policies also limit who they cover. They may insure only officers and directors, or they may extend coverage to employees and volunteers. Oftentimes, the directors are unaware of these limitations until a claim is filed against them, their organization, their staff, or their volunteers.

Federal and state laws also fail to shield nonprofit directors. After 10 years in the making, the Volunteer Protection Act of 1997 (VPA) – the key federal law protecting nonprofit directors – does not cover most organizations unless they have purchased D&O insurance.

The VPA also fails to protect directors against employment-related claims, which are the types of claims that are most often brought against directors.

Finally, the VPA does not cover directors at all if their actions are

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alleged to be grossly negligent. As a number of trustees of colleges across the country have discovered, this means that the law may not protect them when angry parents sue over the deaths of their sons and daughters from alcohol poisoning. State laws have additional limitations – something that directors usually discover after they have been named as parties in a lawsuit.

In the absence of sufficient insurance or laws to protect nonprofit directors, we propose that states amend their nonprofit corporation acts to cap damages for directors' actions at \$25,000 per incident. States that pass this kind of legislation will potentially save their nonprofit organizations millions of dollars.

At the same time, eliminating D&O insurance premiums could result in a billion-dollar infusion of money each year into the nonprofit sector. Organizations can then use this windfall for scholarships, affordable housing, youth activities, and other socially beneficial ends.

How Caps Work

Although directors of nonprofit organizations have not yet paid significant sums of their own money to settle a lawsuit, the risk of that happening is growing. The Enron and WorldCom scandals set new precedents for the personal liability of directors. Ten Enron directors paid a total of \$13 million to settle shareholder lawsuits. WorldCom's outside directors paid \$18 million out of their own pockets.

Meanwhile, Sen. Charles Grassley's inquiries into actions of the board of trustees at American University and Smithsonian Secretary Lawrence Small indicate that the public is paying a lot more attention to nonprofit governance. Their increased

demand for board accountability could easily evolve into personal financial liability for board members.

If the directors of a reputable nonprofit organization who thought they were covered by D&O insurance were forced to pay a substantial part of their net worth to settle a claim, high net worth individuals across the country would resign from boards in droves. Caps on damages could forestall such an exodus by limiting board members' liability – a liability that

Despite its high cost, directors and officers insurance does not adequately protect nonprofit board members. But state legislatures can offer this protection.

seems all the more unreasonable considering that most nonprofit directors are unpaid volunteers.

A cap of \$25,000 would be large enough to encourage good governance, but small enough to discourage lawyers from pursuing litigation. Moreover, in order to protect directors adequately, the cap on damages should apply regardless of whether directors' acts were wanton, willful, or grossly negligent.

At first blush, this cap might seem like a "get out of jail free" card for directors. But the new cap on damages would not protect directors from

criminal prosecution, nor would it put a ceiling on the amount that nonprofit organizations themselves would have to pay.

For example, a patient who contracted a disease in a hospital because of unsanitary conditions could still sue the hospital for millions of dollars. She just could not sue the directors for more than a total of \$25,000.

There are many precedents for caps on damages. Massachusetts limits damages for civil wrongs committed by nonprofit organizations to \$20,000. New Jersey has a cap of \$250,000 for nonprofit healthcare providers. And New Hampshire limits liability for nonprofit organizations to \$250,000 per claimant.

The federal government has also capped damages in other arenas for a number of years. As early as 1908, the Federal Employers' Liability Act limited amounts paid to injured railroad workers. The Longshore and Harbor Workers' Compensation Act has likewise restricted payouts to workers engaged in employment related to "navigable waters" since 1927. The Supreme Court and lower courts have upheld caps on damages for nuclear disasters, swine flu immunizations, atomic weapons testing, and childhood vaccines.

Gaps in existing legislation and in D&O insurance policies allow plaintiffs to drag directors into expensive and time-consuming litigation. Even the mere threat of litigation involving directors and officers sometimes forces nonprofit organizations into unfavorable settlements.

States have the opportunity, the authority, and perhaps the obligation to protect nonprofit directors from these lawsuits. By tightening the wording of their statutes, state legislatures can offer this protection. □