

Advising the Nonprofit Board on Director & Officer Insurance Policy Protections

In the current economic environment, nonprofit general counsel should be proactive in addressing the following D&O insurance issues on the board's behalf:

1. **Who else is an "Insured Person" or Sharing Your Limit?** Nonprofit D&O insurance policies insure directors and officers, but many policies also extend "Insured" status to others. The scope of the "Insured Persons" category and other Insureds should be reviewed in conjunction with any shared limits being afforded by the policy.
2. **How Concerned Should a Director be about Coverage Limits?** The more encompassing the "Insured Person" definition, the greater the risk to directors that claims brought against others might erode or use up shared limits of the D&O insurance policy. If directors are concerned that coverage limits could be diluted or used up by claims against *non*-director Insureds, they may wish to explore a supplemental purchase of a dedicated limit policy (such as a Side A-*only* policy confined to directors) or an independent directors' liability insurance policy. The analysis of limits might be affected by a variety of factors, including whether applicable law confers meaningful limitations on the legal exposure of nonprofit directors.
3. **Circumstance-Reporting and Minimizing Rescission, Gap, or Litigation Risks.** D&O policies confer a valuable extension of coverage: the ability to report a circumstance which, although not yet a claim, may give rise to a potential future claim where facts regarding the circumstance can be reported to the insurer with the requisite specificity; under many policies, a future claim will relate-back and be deemed to have been first-made at the time of the circumstance report. *Traps for the unwary:*
 - Although circumstance-reporting of a potential future claim may be described in the policy as permissive (as if *optional*), the insurer's renewal application may effectively render such a report to the about-to-expire policy *mandatory*;
 - A gap-risk might result if there is disclosure of a potential future claim on a renewal underwriting application without compliance with the about-to-expire policy's circumstance reporting requirements (which often specify that a detailed circumstance notice must be received at the "claims department" of the expiring insurer(s) prior to expiration of the current policy period);
 - When dealing with circumstance-reporting under a D&O policy, what channels of communication and internal procedures will be used to protect and maintain sensitive and privileged communications, to seek any required insurer consents prior to incurring defense expense or other loss, and/or to address document preservation issues appropriately?
4. **Accessing Policy Proceeds in Times of Financial Stress.** Normally, directors and officers look to the organization for indemnification in the event of a claim, and it is the organization which seeks reimbursement under the D&O policy. But what risks arise from organizational solvency concerns? One peril for unwary directors can be the inclusion in the D&O policy of "Entity" coverage(s), or the combination of D&O insurance with other coverage lines (such as Employment Practices Liability) on a shared aggregate basis, rendering D&O insurance vulnerable to erosion from other claims. In the event of insolvency of the nonprofit organization, a contention that "the policy is an asset of the organization's estate" may impede directors' ability to access policy proceeds at a time when access to the policy proceeds are most needed to fund their own defense. *Some advance planning at policy renewal time can enhance the directors' ability to access (or improve ability to secure a prompt favorable determination of a right to access) D&O policy proceeds, thereby enabling the organization to satisfy its indemnification obligations and receive the benefit of its insurance bargain:*
 - **Priority-of-payment provision** – Seek a provision that requires (human) Insured Persons to automatically be given access to policy proceeds ahead of both the organization's reimbursement rights and any "Entity" coverage in the policy.
 - **Bankruptcy provision** – Seek a provision that explicitly establishes the intention of the policyholder that the policy protect and benefit the (human) Insured Persons first and foremost (including a waiver of the automatic stay and an agreement not to oppose efforts of the insurer or an insured to obtain relief from the automatic stay).
 - **Zero SIR** – Regardless of amount of the Self Insured Retention (SIR) for Side B (Organization Reimbursement) claims, seek an SIR that drops to "zero" or "nil" for "Side A claims" (those claims against "Insured Persons" which have not been indemnified by the organization).
 - **Pay Attention to Premium Details** – Pay the full policy period's premium, and avoid premium financing. Seek multi-year Extended Reporting Period ("tail") options at attractive pre-set premium pricing as part of the terms for policy renewal; this may provide greater flexibility and protection in the event of future cancellation or nonrenewal.
 - **Narrow Unsuitable Exclusions** – Would claims against directors brought by a bankruptcy trustee, creditor committee, and/or a debtor-in-possession be covered or excluded? Would creditors' tort claims arising out of a contractual relationship be covered or excluded? Does wording minimize the extent to which misconduct by others can be imputed to Insured Persons, such as directors.

Projected Corporate Governance Trends for Nonprofit Organizations

A review of current developments has led me to the following perspective on governance trends for 2009:

- 1. Financial Oversight.** Nonprofit directors will be expected to demonstrate an enhanced awareness of the organization's financial condition during the current economic turmoil. This is particularly the case for committees with board delegated powers (e.g., finance, audit). As financial stress increases, so should the frequency of financial updates from management (with special attention to compliance with debt covenants).
- 2. Premium on Business Judgment.** In the current climate, nonprofit regulators may increasingly be compelled to hold boards more directly accountable than before for "preventable" harm/loss to charitable assets. This will place a premium on the exercise, and documentation, of business judgment by the board. Special focus will be on positioning the board to render informed decisions (e.g., enhanced information flow; presentation of options/risk assessments; access to general counsel and outside experts).
- 3. Enhanced Compliance Focus.** Regulators are sensitive to the temptation for nonprofits to engage in problematic business transactions in response to severe budgetary pressures. The board and compliance committee will thus be expected to exercise greater oversight of proposed business ventures, the solicitation and management of restricted gifts and the staffing/funding of the compliance program.
- 4. Executive Compensation.** The combination of the economic climate, regulatory enforcement and legislative criticism create unique challenges for the compensation committee. Special attention should be placed on the composition and process of the committee, its use of market comparability data, transparency, and sensitivity to incentive, retirement and severance benefits.
- 5. Investment Management.** The general market turmoil and emerging "Madoff"-like scandals place new pressures on the standards and performance of the investment committee. Investment manager performance and asset allocation should be closely monitored. Full board oversight of, and regular interaction with, the investment committee will be a regulatory (and donor) expectation.
- 6. Director Independence.** Board composition matters will be of increasing importance given the new Form 990 and its focus on director independence and the new IRS definition of "independent director." Particular attention will be placed on board awareness of the underlying policy concerns re: independent directors, as well as (more specifically) on the number of independent members of the board and of key committees.
- 7. Conflicts Management.** The entire conflicts of interest process, from education to disclosure to review to conflicts management, will be a board priority. Special focus will be on intra-board relationships, non-financial conflicts, conflicts arising from overlapping boards and officers, and donors/directors as vendors.
- 8. Financial Irregularities.** The board will be expected to affirm the sufficiency of internal financial controls in response to a documented, dramatic increase in financial fraud committed against nonprofits (e.g., investment and charitable donation "scams," embezzlement, "revenue management," improper accounting entities, material expense report abuse).
- 9. Director Recruitment and Retention.** Efforts to recruit and retain competent, experienced directors should be enhanced, given the increasing challenges associated with voluntary board service. Emphasis should be placed on board programs and benefits that are supportive of such service; e.g., full D&O insurance/indemnification coverage, ongoing director education programs, adequate and timely information flow, effective conflicts of interest management, and-possibly-director compensation.
- 10. The Appetite for Risk.** A likely byproduct of the emerging "climate of responsibility" is the avoidance of risk by the board; e.g., the perception that aggressive risk taking is primarily responsible for current conditions. Yet, fiduciary principles promote informed risk-taking. Boards must balance liability avoidance in an unforgiving environment with assuming prudent risks on behalf of the organizational mission.

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Advising the Nonprofit Board on its Financial Oversight Responsibilities

Given the current economic turmoil, nonprofit directors can be expected to seek guidance from general counsel on their financial oversight duties. The following are some suggested responses for the general counsel:

- 1. Solvency and the Duty of Care.** Nonprofit directors have a duty to maintain an awareness of the organization's financial condition. In particular, enhanced oversight is expected from committees with related board-delegated powers (e.g., finance and audit). Should the organization approach insolvency, the risk of creditor claims for breach of fiduciary duty will increase. Accordingly, as financial stress increases, so should the frequency of financial updates from management.
- 2. Solvency and the Duty of Loyalty.** Adherence to the duty of loyalty is a critical risk factor during periods of economic turmoil. Both the board and key committees (e.g., finance, audit and investment) should be subject to periodic, close review for potential conflicts of interest, and independence concerns. Conflicts disclosure practices should be enhanced.
- 3. Reliance.** Nonprofit directors are entitled to rely on the opinions and reports of management, committees with board-delegated powers, and outside advisors on financial matters, in the absence of any suggestion that such reliance may be misplaced (e.g., conflicts, questions as to expertise). Such reliance does not, however, excuse the continuing exercise of business judgment and constructive skepticism by board members.
- 4. Debt Covenant Compliance.** Debt covenants under bond indentures and commercial loan documents act as an "early warning" system for an organization's declining financial performance. Directors need to understand the organization's debt covenants, monitor compliance continuously, and assure prompt disclosure of any violations and other material adverse events. Covenant violations must not be ignored or lightly considered, as these occurrences could threaten the organization's credit worthiness, imperil planned and future financings, and provide bondholders and other lenders with strong remedies.
- 5. Investment Portfolio.** In light of the unprecedented volatility in the equity and debt markets, nonprofit directors should periodically review the organization's investment policy and continuously monitor the performance of its investments. Particular attention should be paid to the status of any interest-rate swaps and other derivative securities. If the organization has suffered extraordinary investment losses, the board should consider major steps to preserve remaining capital and to address any inquiries from major donors and state Attorneys General. Such steps could include examining the performance of existing investment managers and rebalancing the allocation of invested assets.
- 6. Revenue/Expense Management.** The board should work closely with management to assure that the organization (a) maintains adequate cash reserves and liquid investments, to protect operations from a precipitous decrease in revenues; and (b) is being operated in a cost-efficient manner and considers as necessary sensitive expense reduction options (e.g., reductions in workforce, salaries and pensions).
- 7. Strategic Flexibility.** Directors must be prepared to consider alternative strategic options through which the charitable mission can continue to be pursued. Change of control, partnering or similar opportunities should be evaluated where appropriate.
- 8. Restructuring and Bankruptcy.** Should the organization approach insolvency, directors should be briefed on the benefits and burdens of a non-judicial debt restructuring or bankruptcy reorganization. Consideration of these options should be made before cash/liquid assets are depleted and/or operations are irreversibly impaired.
- 9. Third-Party Concerns.** Director conduct during economic stress will be subject to review not only by creditors, but also by charity regulators and even by donors. Particular scrutiny will be on exercise of business judgment generally, as well as on compliance plan oversight. The board should thus have regular access to the general counsel and be advised of the protection afforded by – and limitations of – its "D & O" liability coverage.

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The Nonprofit Investment Committee in Tough Times

A review of current developments leads us to the following perspectives on how the investment committees of nonprofit corporations may be affected by evolving market conditions, and related regulatory responses.

- Committee Culture.** The expectation is that investment committees will be particularly diligent during the current financial crisis. Such diligence can be manifested by: (i) approaching investment advisers for guidance as to prudent investment strategies in the turbulent marketplace and for an explanation of past and current economic performance (which likely will be negative); and (ii) understanding the ramifications for the nonprofit of recent consolidations and reorganizations within the financial services community.
- Full Board Oversight.** Full board oversight of, and regular interaction with, the investment committee is particularly crucial during periods of market turmoil. The board is ultimately responsible for monitoring and understanding the impact of such turmoil on the organization's investment portfolio. It may be advisable to form a working group from the governing board, executive committee and investment committee to closely monitor the organization's investments during the economic downturn.
- Confirm Compliance with UPMIFA.** The Uniform Prudent Management of Institutional Funds Act, in various forms, has been adopted in multiple states. This statute codifies the requirement of prudent investment by charitable organizations. During this economic downturn, it will be crucial for tax-exempt organizations to work with their General Counsel to confirm that their investments and investment decision-making comply with UPMIFA and consider the impact that this statute may have on ongoing investment decisions during a recession.
- Committee, Staff Qualifications.** Even before the recent financial crisis, concerns arose from multiple sources regarding the sophistication, background and training of investment committee members and investment management staff of nonprofit organizations. The board should join with the investment committee in reviewing the qualifications (and disinterest) of existing committee members and staff and the sufficiency of the selection and hiring process, on an ongoing basis.
- Transparency.** The investment committee should anticipate an increased volume of questions on investment performance from donors, governmental agencies, the media and the general public. Staff and the governing board should be prepared to answer any questions regarding the performance of the organization's investments. In this regard, consistency is important and any statement should be carefully vetted by both counsel and investment advisers.
- Dealing with Extraordinary Losses.** If the organization has suffered extraordinary investment losses, the investment committee may wish to recommend major steps to preserve remaining capital and to address any inquiries from major donors and state Attorneys General. This could include board inquiry into the performance of existing investment managers, and whether asset allocation and board and committee procedures should be reformed to avoid additional losses.

 NOTE: Constant communication between the board, investment committee, finance committee and officers about the effects of losses on other obligations, e.g., bond financing covenants and pension funding requirements . . . is crucial.
- Increased Attorney General Scrutiny.** The state Attorney General has primary regulatory jurisdiction with respect to preservation of nonprofit assets and the related exercise of fiduciary duties. Accordingly, it is reasonable to expect increased Attorney General interest in the investment performance of nonprofits during the current market turmoil. Particular scrutiny may be prompted by disclosures of extraordinary losses, exceptionally aggressive investment decisions and lack of board oversight of the committee and of investment advisors.
- IRS Interest.** Investment committees should recognize the relationship between investment management practices and preservation of federal tax-exempt status. The Internal Revenue Service (IRS) has expressed interest from a compliance perspective in investments by charities in "complicated or sophisticated" financial products that require financial investment expertise. Specific IRS focus is placed on written policies and procedures governing such investments, and on the terms of compensation arrangements with investment advisors.

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Potential Impact of Current Economic Conditions on Nonprofit Governance

A review of current developments has led me to the following perspectives on how the governance of nonprofit corporations may be affected by the evolving economic conditions, and related regulatory responses:

- 1. Premium on Business Judgment.** Although not a principal contributor to the current crisis, nonprofit corporations – and their governance – are unlikely to escape collateral damage from what appears to be an emerging climate of “finger pointing,” in which attempts to assess blame, and to attribute responsibility to the board, will be the order of the day. In this climate, charity regulators may be increasingly compelled to hold nonprofit boards more directly accountable than before for “preventable” harm/loss to charitable assets. This will place a premium on the exercise, and documentation, of business judgment by the board.
- 2. Executive Compensation.** Adoption of the Emergency Economic Stabilization Act of 2008 (“EESA”) has opened a “Pandora’s Box” of executive compensation issues, all of which are likely to have a spillover effect on the nonprofit sector. The EESA has introduced into mainstream discourse such previously “taboo” subjects as: (a) ceilings on total compensation; (b) “clawbacks” on incentive compensation based on metrics later proven to have been merely inaccurate (an expansion of Sarbanes-Oxley principles); (c) restrictions on “golden parachutes” and other severance or retirement benefits perceived as excessive; and (d) limitations on compensation incentives tied to “unnecessary and excessive risks” that threaten the value of the organization. The nonprofit executive compensation committee will want to consider the policy implications of these provisions, together with other similar developments (e.g., the *Care First, Grasso* decisions).
- 3. Investment Management.** Experience suggests that any downturn in the securities markets will prompt focus on investment practices by individual nonprofit organizations that result in investment losses, causing economic harm to the investing entity and, where applicable, to the operating charity that is to be supported. Extraordinary losses attributed in large part to investment strategies subsequently perceived as imprudent may be subject to scrutiny by state charity officials, notwithstanding the protections afforded by liberal state investment management laws (e.g., UPMIFA – the Uniform Prudent Management of Institutional Funds Act). The current volatility in the securities markets mandates greater attentiveness on the part of investment committees and governing boards of nonprofit organizations with respect to their fiduciary duty to invest prudently. Moreover, it will become increasingly important for investment decision-makers to properly memorialize the processes and considerations by which investments decisions are made.
- 4. Tax Exemption Pressures.** The likelihood of an increased individual income tax burden to finance the recent extraordinary government “bailout” measures may place additional pressures on nonprofit organizations to justify their tax exempt status. This comes as many in both the public and private sectors have begun questioning whether the public benefits that tax exempt organizations are providing are commensurate with such organizations’ resources and the tax subsidies they receive. This questioning is also consistent with an environment which is less willing than before to extend nonprofits the benefit of the doubt. Nonprofit boards must be sensitive to growing skepticism regarding whether they “deserve” tax exemption.
- 5. Governance Practices.** Boards should expect additional scrutiny on the extent to which they have adopted the latest round of governance best practices (e.g., Panel on the Nonprofit Sector, IRS, Smithsonian). The current economic climate appears to be prompting a broad repudiation of the concept of self-regulation. This climate is being compounded by a perception that Sarbanes-Oxley may not have been the “magic elixir” of corporate responsibility it was intended to be. Practices relating to director qualifications and length of tenure (e.g., excessive), and frequency of board/committee meetings (e.g., too infrequent), may be areas of particular focus. Given this, more action may be expected from nonprofit boards in terms of governance oversight and controls.

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A likely byproduct of this emerging climate of accountability is the avoidance of risk by the board; e.g., the perception that aggressive risk-taking is primarily responsible for current conditions. Yet, fiduciary principles promote the taking of informed risk by the nonprofit corporation. The challenge going forward is how to balance liability avoidance in an unforgiving environment with assuming prudent risks on behalf of the charitable mission.