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AVOIDING LIABILITY EXPOSURES OF DIRECTORS, TRUSTEES AND OFFICERS OF CALIFORNIA NONPROFIT CORPORATIONS

(Nonprofit Advisory No. 2)

Directors, trustees, officers and volunteers of nonprofit corporations frequently ask us about their potential liability for the activities conducted on behalf of their nonprofit corporation.

This Advisory is a brief discussion of the liability exposures of directors, trustees, officers and volunteers, paid and unpaid; the means of reducing such exposure to the individual; and explains how to avoid personal monetary losses.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your circumstances with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by distribution of this Advisory.

Exposure to Liability. Usually, a nonprofit director, trustee or officer's exposure to liability arises in one of three ways:

- (1) Lawsuits relating to the corporation's activities in which the nonprofit director, trustee or officer WAS physically involved; or
- (2) Lawsuits relating to the corporation's activities in which the nonprofit director, trustee or officer WAS NOT physically involved; or
- (3) Lawsuits arising from a nonprofit director's, trustee's or officer's decision or lack of decision (or their "error or omission").

The California Legislature has declared that volunteer services of officers, directors and trustees and volunteers of nonprofit corporations are critical to public service and the charitable affairs of California. Legislation has been enacted to reduce the exposure of nonprofit volunteers to personal liability and personal monetary losses for their charitable activities.

1. *Corporate Activities.* In conjunction with categories (1) and (2) above, your exposure to liability for activities of a corporation is usually dependent on whether you were physically involved in the specific activity giving rise to the liability. If you were physically involved, you have exposure to personal liability along with the corporation. If you were not physically

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involved, you do not have liability exposure so long as the corporation is legally operating as a corporation, and not as an association of individuals. An example would be a car accident caused by an individual in the course of carrying out nonprofit activities. If you were the person who caused the accident, then you could be held personally liable along with the corporation. If you were not involved, you would not be personally liable.

To avoid liability for these types of exposure, your corporation can:

- (a) Carry liability insurance;
- (b) Carry errors and omissions insurance;
- (c) Provide for a complete or partial indemnification of officers, directors, and others involved through the Bylaws, Articles or by separate agreement; and,
- (d) Handle its affairs as a corporation, so that its “corporate veil” is not “pierced.” If corporate formalities are not followed, an entity may be treated as an association of individuals, like a partnership, with each person individually liable for each other’s activities. Corporate formalities include noticed meetings, voting procedures, Board resolutions and actions, the keeping of minutes and other appropriate records as well as other procedures that are required of corporations. Our firm, for example, has a Business Compliance Program to review corporations yearly to ensure that corporate formalities are observed and individual exposure to liability limited.

2. *Errors and Omissions.* The more significant concern of nonprofit directors, trustees and officers is the potential for liability for decisions made or failure to take action. Usually, these types of suits are filed when the nonprofit corporation has few assets and minimal insurance coverage in comparison to the damages experienced by the claimant.

For example, if a child is severely and permanently injured while attending a nonprofit corporation’s outing, the officers, directors and/or trustees might find themselves facing a lawsuit for their decision to allow the outing, their failure to stop the outing, the lack of supervision, etc.

Methods of Avoiding Your Exposure. The exposure of nonprofit officers, directors and/or trustees to personal liability and damages is significantly reduced by the following means:

1. *General Protection for Directors and Officers of Nonprofit Corporations (Corporations Code § 5047.5).* The California Legislature enacted Corporations Code Section 5047.5 to protect nonprofit corporations (and their directors, officers and trustees) organized to provide charitable, educational, scientific, social or other forms of public service

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that are exempt from federal income taxation under Section 501(c)(3) or 501(c)(6) of the Internal Revenue Code. Section 5047.5 states that any director or officer of a public benefit, mutual benefit, or religious nonprofit corporation serving without compensation¹ cannot be sued for any negligent act or omission occurring 1) within the scope of that person's duties as director acting as a board member or within the scope of that person's duties as an officer acting in an official capacity; 2) in good faith; 3) in a manner that the person believes to be in the best interest of the corporation; and 4) in the exercise of his or her policymaking judgment.

However, the general protection provided above does not serve to limit a director or officer's liability for the following actions:

- (a) Self-dealing transactions, (see Corporations Code §§ 5233 and 9243);
- (b) Conflicts of interest, (see Corporations Code § 7233);
- (c) Actions involving loans and distributions (see Corporations Code §§ 5237, 7236, and 9245);
- (d) In the case of a charitable trust, an action or proceeding against a trustee brought by a beneficiary of that trust;
- (e) Any action or proceeding brought by the Attorney General;
- (f) Intentional, wanton, or reckless acts, gross negligence, or an action based on fraud, oppression, or malice; and
- (g) Any action involving restraint of trade brought under Chapter 2 (commencing with Corporations Code § 16700) of Part 2 of Division 7 of the Business and Professions Code.

In addition to the basic requirements set forth above, Corporations Code § 5047.5's protection applies only if:

- (a) The corporation maintains a general liability insurance policy that provides coverage of (1) at least \$500,000, if the corporation's annual budget is less than \$50,000, or (2) at least \$1,000,000, if the annual budget is \$50,000 or more; and

1. Reimbursement for expenses does not constitute compensation but if director or officer is also an employee of the corporation then that person is not covered under this section.

- (b) the claim against the director or officer may also be made directly against the corporation and a general liability insurance policy is in force both at the time of injury and at the time the claim against the corporation is made, so that a policy is applicable to the claim. If a general liability policy is found to cover the damages caused by the director or officer, no cause of action shall be maintained against the director or officer.

Although the director or officer may not be liable under this Section 5047.5, the corporation remains liable for the negligent act or omission of a director, officer, employee, agent, or servant occurring within the scope of his or her duties. Further, the liability exemption does not apply to any corporation that unlawfully restricts membership, services, or benefits conferred on the basis of race, religious creed, color, national origin, ancestry, sex, marital status, disability, political affiliation, or age.

2. *Public Benefit and Religious Corporations Protection for Negligent Acts (Corporations Code §§ 5239 and 9247)* With respect to public benefit and religious corporations, volunteer executive officers, directors and trustees of such corporations are relieved of all personal liability to third parties for monetary losses caused by their negligence in the course of corporate activities, including errors and omissions in decisions, provided that all of the following are satisfied:

- (a) The act or omission was within the scope of their duties, was performed in good faith, and was not reckless, wanton, intentional or grossly negligent;
- (b) The individual served without compensation as a director or an “executive officer” (includes typical officers of a corporation and such other persons who serve in like capacity); and
- (c) The damages are covered by the corporation’s general liability policy, director’s and officer’s liability insurance, or the director’s or executive committee officer’s personal insurance. In the event that there is no insurance coverage, the volunteer director or executive officer is not personally liable as long as the Board of Directors and the subject person made all reasonable efforts in good faith to obtain insurance coverage.

Public benefit corporations that qualify under Internal Revenue Code Corporations Code § 501(c)(3) and which have an annual budget of less than \$25,000 satisfy the “reasonable efforts to acquire insurance” requirement if they make at least one inquiry per year to purchase a general liability insurance policy and the insurance was not available at a cost of less than 5% of the corporation’s previous year’s annual budget. The inquiry must be for a General Liability policy with a minimum coverage of \$500,000. Corporations Code § 5239(h).

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Thus, to qualify for this relief, the director, officer, or trustee must either (1) be sure the requisite insurance is obtained or (2) be sure that the minutes memorializing corporate actions each year state that the corporation exercised due diligence and reasonable efforts to obtain insurance but was not successful due to the high costs of insurance, lack of funds or for other reasons.

3. *Protection for Failure to Discharge Duties* There is no monetary liability on the part of, and no cause of actions for damages shall arise against, any nonpaid director of a nonprofit public benefit², mutual benefit³, or religious corporation⁴ based upon any alleged failure to discharge the person's duties as director or officer if the duties are performed in a manner that meets all of the following criteria:

- (a) the duties are performed in good faith and in a manner such director believes to be in the best interests of the corporation; and
- (b) the duties are performed with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

4. *Corporate Indemnification.* Notwithstanding any of the foregoing, your corporation's articles and/or bylaws and/or contract can provide that the corporation will indemnify you for all losses, attorneys' fees, expenses, etc., sustained because of your corporate activities. This indemnification, however, is only as good as the assets of your corporation, as there is no personal liability of officers, directors and/or trustees for the corporation's obligation to anyone, including another nonprofit director who is being sued for his/her corporate activities.

5. *Corporate Insurance.* Many corporations, whether profit or nonprofit, maintain director's and officer's liability insurance, also known as "D&O" or "E&O" insurance to protect officers and/or directors. You should review any policy to know the amount of the coverage and the circumstances under which it applies. Even if the premiums of such coverage are high, it is usually suggested that a minimal policy be maintained so that the costs of defense (attorneys' fees) are available to you to defend yourself in conjunction with any litigation.

6. *Personal Insurance.* Many nonprofit directors, trustees and officers rely on their own personal liability or umbrella insurance policies to protect them against liability. Some insurance carriers automatically include coverage for activities involving nonprofit corporation as part of the personal general liability or umbrella insurance coverage provided. You should review your

2. Corporations Code § 5231.5

3. Corporations Code § 7231.5

4. Corporations Code § 9241

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personal insurance policy and discuss it with your insurance agent to determine the extent of the coverage and any exemptions which might relate to your nonprofit corporate activities.

Of course, there is no substitute for paying attention, using good judgment and exercising appropriate supervision and control in your nonprofit corporate activities and consulting with your attorneys, as necessary.

Hopefully, this Advisory will assist you in evaluating the potential exposure you may have in conjunction with your corporation's nonprofit activities and knowing how to direct your corporation to minimize that exposure.

As always, you should be sure that additional legislation has not been enacted or court decisions rendered, that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. You should discuss your individual circumstances with us or your own attorney.

S. Timothy Buynak
Business and Tax Attorney

This Advisory is one of a series of business and tax advisories prepared by the attorneys at Buynak, Fauver, Archbald & Spray. Should you have further questions regarding the information provided in this Advisory, please contact the author at the number listed below.

Buynak, Fauver, Archbald & Spray provides business legal services to individuals, business entities and non-profit organizations from entity formation and start-up, through day-to-day operations and exit strategies.

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