



Directors and Officers
Liability Insurance
and Indemnification

Second Edition

John A. Edie and Jane C. Nober



COUNCIL *on* FOUNDATIONS



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VISION

The Council's vision for the field is of

A vibrant, growing and responsible philanthropic sector that advances the common good.

We see ourselves as part of a broad philanthropic community that will contribute to this vision. We aim to be an important leader in reaching the vision.

MISSION

The Council on Foundations provides the opportunity, leadership and tools needed by philanthropic organizations to expand, enhance and sustain their ability to advance the common good.

To carry out this mission, we will be a membership organization with effective and diverse leadership that helps the field be larger, more effective, more responsible and more cooperative.

By *common good* we mean the sum total of conditions that enable community members to thrive. These achievements have a shared nature that goes beyond individual benefits.

By *philanthropic organizations* we mean any vehicle that brings people together to enhance the effectiveness, impact and leverage of their philanthropy. This includes private and community foundations, corporate foundations and giving programs, operating foundations, and public foundations, as well as emerging giving and grantmaking mechanisms involving collective participation.

STATEMENT OF INCLUSIVENESS

The Council on Foundations was formed to promote responsible and effective philanthropy. The mission requires a commitment to inclusiveness as a fundamental operating principle and calls for an active and ongoing process that affirms human diversity in its many forms, encompassing but not limited to ethnicity, race, gender, sexual orientation, economic circumstance, disability and philosophy. We seek diversity in order to ensure that a range of perspectives, opinions and experiences are recognized and acted upon in achieving the Council's mission. The Council also asks members to make a similar commitment to inclusiveness in order to better enhance their abilities to contribute to the common good of our changing society.

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COUNCIL *on* **FOUNDATIONS**

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Introduction

For boards of directors, trustees and foundation managers, there are few areas of operation that cause more confusion and uncertainty than indemnification and the purchase of directors and officers (D&O) liability insurance. And it is no wonder. Mixing the often impenetrable statutory language of the Internal Revenue Code with the highly refined wording of insurance policies creates fertile ground for confusion. To make matters worse, the rules are not static. State laws change, Treasury regulations are revised and insurance policy language is frequently amended.

Over the years, members of the Council on Foundations have raised a steady stream of questions about potential liability, indemnification and the purchase of D&O insurance. These questions have taken on more urgency as the increased scrutiny of directors of for-profit corporations has led many state regulators to focus their attention on the behavior of nonprofit officials as well. Foundation managers increasingly recognize that their leadership roles come with potential risks, and they want to know how to protect themselves and the foundations they serve.

This paper seeks to address these concerns. It brings together background information on relevant state laws, the insurance industry and Treasury Department regulations, for those who are approaching these issues for the first time and for those who seek to update and deepen their knowledge.

The information is presented in a question-and-answer format with specific references to attached materials that provide more detailed discussion of the issues covered. At the outset, a few points should be emphasized:

- While this paper's intended audience is grantmaking foundations, much of the information will be useful to public charity organizations that are primarily service providers.
- Most of the information provided here does not relate to potential liability for personal injury or property damage—risks not covered by D&O insurance. Charities providing services directly to the public will need to conduct a more extensive review of their total operations to be certain that all potential risks are thoroughly covered.

- The information provided is aimed primarily at issues encountered by private and community foundations; where problems are applicable only to private foundations, they are clearly identified.
- The focus is primarily on potential areas of liability for the individual foundation director or trustee. However, this paper treats potential liability of the organization as well. In many cases both the individual and the foundation may be liable.
- The information in this publication is not intended as legal advice. Nothing in this work is a substitute for the opinion of a knowledgeable legal counsel who is familiar with the specific situation of a particular foundation. You should not make any decision regarding self-indemnification or the purchase of D&O insurance without consulting your lawyer and other risk assessment professionals.
- There is enough complexity in this field to confuse everyone. So that we may make this document as useful and relevant as possible, your comments and suggestions for improvements are encouraged.

Jane C. Nober
July 2007

PART I

What Are the Real Risks?

Question 1: **What is general liability insurance?**

Most nonprofit organizations would not think of doing business without some form of comprehensive general liability insurance to cover fire, theft and accidental loss. While such a policy is usually very broad in its coverage, there is always one very important limitation: general liability insurance covers only losses that arise as the result of bodily injury or loss of physical property (including damage).

There are two other kinds of insurance that are fairly common: workers' compensation and fidelity insurance. Workers' compensation covers injuries (or illness) and lost wages of employees who are injured in the course of their employment. The coverage is normally required by law and covered by a separate policy.

Fidelity insurance protects the organization from acts of theft or embezzlement committed by dishonest employees or volunteers. Many package type policies will include fidelity insurance so that the organization will be reimbursed for any such losses resulting from dishonesty or embezzlement; if they do not, separate coverage is easily obtained. It is important to note that D&O insurance policies will specifically exclude coverage for workers' compensation and losses resulting from acts of dishonesty.

Question 2: **What potential risks are not covered by general liability insurance?**

Liability that is not related to bodily injury or property damage can develop from three sources: general common law, federal law and state/local statutes. Common law generally means that rules have developed over time as the result of court decisions (precedent). A lawsuit or administrative action against a foundation may result in the foundation being found liable under common law for libel, slander, false imprisonment, breach of contract, breach of fiduciary duty, conflict of interest, mismanagement of funds, failure of supervision or impru-

dent investments (most states have incorporated many of these violations into statute as well).

There are a number of penalties under federal laws that could be imposed upon a foundation or its officers/directors even though no personal injury or property damage has occurred. These include penalties for:

- Failure to withhold or pay social security tax (includes penalty on the manager)
- Failure to withhold or pay federal income taxes of employees (includes penalty on the manager)
- Violation of the Securities Exchange Act
- Violation of the Occupational Safety and Health Act
- Violation of an environmental protection act
- Violation of the Employee Retirement Income Security Act
- Violation of the Internal Revenue Code
- Violation of the Equal Employment Opportunity Act.

At the state and local level, similar laws may be in place. For example, states usually require withholding of state income taxes and may also have a state equal employment opportunity statute. Failure to pay state sales tax may also result in liability (not all states permit all nonprofits to be exempt from sales tax). States, cities and counties may also have building codes, fire codes or other health and safety codes (for example, to cover food service or the operation of a child care center), violations of which can subject the organization to penalty.

For the average grantmaking organization, some of these statutes are not relevant. However, some laws are specifically aimed at the nonprofit community and we will consider them more closely (see questions four and five). Foundations and other nonprofits should also be keenly aware that most states empower the state attorney general to protect the public interest when assets have been contributed to charity (on the theory that the general public has a right to benefit from the assets contributed). In other words, not every action against the organization will be a lawsuit claiming damages. The attorney general may bring an administrative action to force the organization (or its board) to perform (or not perform) a specific act. Examples might include paying back excessive fees or compensation, or forbidding the continued use of the foundation's offices for personal business.

Question 3: When it comes to liability, is there any difference between being a trustee and being a director?

While most nonprofit organizations today are formed under the state's not for profit corporation statute, it certainly is possible to form a private foundation or community foundation under state trust laws. The nonprofit corporation will have a board of directors and the trust will have trustees. Does this make any difference in liability? It can.

Historically, trust law holds trustees to a higher standard. Trustees cannot participate in any actions where a conflict of interest arises, whereas corporate directors can do so as long as the conflict is disclosed and the transaction is approved by a majority of disinterested board members or by a disinterested third party.* Trustees are sometimes more limited in the duties that they may delegate to others (such as responsibility for investment decisions). Also, trustees are often held to a stricter standard regarding negligence. Corporate directors can usually rely on a standard called the "business judgment rule" which simply requires the director to employ the care that "an ordinarily prudent person would exercise in a like position and under similar circumstances."

In more recent years, the degree of liability and responsibility for trustees has become less and less distinguishable from that applied to corporate directors, as more and more courts adopt the corporate standards. However, in some states important differences may still remain for certain kinds of actions. Consequently, if your organization is a trust, it is prudent for your board to clarify with legal counsel what stricter standards may apply in your case. However, for purposes of this paper the term "director" will include the term "trustee." For many of the taxes and penalties that can be levied and for many of the lawsuits that can be filed, there is no measurable difference.

Question 4: What are Chapter 42 taxes and penalties?

The Internal Revenue Code (IRC or tax code) contains several potential penalties that are not covered by general liability insurance (see question two). Private foundations are the only type of organization subject to Chapter 42 penalties. Since 1969, the IRC has strictly regulated the management and administration of private foundations. The bulk of these requirements are found in Chapter 42 of the IRC (they do not apply to community foundations or public charities, but see question five).

Chapter 42 not only introduced specific legal requirements for private foundations, but provided a new enforcement tool: penalty taxes for violations. Under this chapter, penalty taxes may be applied for acts of self dealing (Section 4941), failure to distribute income (Section 4942), excess business holdings (Section 4943), jeopardy investments (Section 4944) and taxable expenditures (Section 4945) such as grants for lobbying or for voter registration or to noncharitable organizations. Except for the rules against self dealing, each of these IRC sec-

* For private foundations in either the trust or corporate form, such actions may violate the rules against self dealing despite full disclosure and board approval.

tions levies a penalty against the private foundation. A similar tax can be imposed on the individual foundation manager (director, officer, employee) for violation of three of the sections: self dealing, jeopardy investments and taxable expenditures. In each case, the penalty is a percentage of the amount of money involved; the initial penalty applied ranges from 10 to 30 percent against the foundation and 5 percent against the individual; if the prohibited acts are not corrected, the penalties may rise to 200% of the amount involved.

Question 5: How many foundations are audited each year and how much do foundations pay in penalty taxes?

Each year the Internal Revenue Service (IRS) reports the total collections for penalty taxes under Chapter 42. For 2003, the latest year for which totals are available, the amount collected was just over \$5 million; this total is fairly small considering that there are over 73,000 private foundations giving away billions of dollars each year.

For fiscal year 2005, the IRS has reported that it audited just under 350 returns filed by private foundations (and by some other types of organizations). Again, this is a fairly small number in comparison to the total number of returns filed by private foundations.

Question 6: Are there fines or penalty taxes that can apply to public charities such as community foundations?

Yes. Intermediate Sanctions are fines imposed under Section 4958 of the Tax Code on certain individuals ("disqualified persons") associated with a public charity (or other tax-exempt organization) who receive compensation in excess of reasonable compensation for the services provided. An initial tax of 25 percent of the excess benefit may be imposed on the disqualified person, and the tax will rise to 200% if the violation is not corrected. An additional penalty of 10% of the amount involved may be imposed on organization managers who knowingly participate in the transaction.

Intermediate Sanctions were added to the Tax Code in 1996 to provide the IRS with the authority to penalize persons improperly benefiting from transactions with public charities and civic organizations. Prior to 1996, the IRS's only weapon against organization insiders who took excess benefits was the revocation of the organization's exempt status.

Question 7: Are there other IRC violations that can subject a grantmaker to penalties?

In addition to Chapter 42 violations, a private foundation or a private foundation manager can be fined for failure to file an annual return in a timely manner or for failure to provide public inspection of the return as required (see Sections 6652 and 6685). Filing an incomplete return on time is the same as filing a late return. Section 6684 can double the penalty tax found under Chapter 42 if the

violation is found to be “willful and flagrant.” The 1986 Tax Reform Act changed the IRC to require private foundations to make estimated quarterly payments of their tax on investment income (Section 6154). Failure to make the minimum estimated payments can result in penalty against the foundation manager (Section 6656).

Community foundations and other public charities can also be subject to IRC penalties. Both the organization and the person responsible can be penalized for failure to file a timely return (Section 6652). If any unrelated business income tax is due (from either a private foundation or a public charity), estimated quarterly tax payments must be made to avoid penalty.

Also, private foundations and public charities (and in some cases their managers) may be fined for:

- Failure to make the organization’s annual tax return (Form 990 or 990-PF) available for public inspection or to provide a copy of the return as required (Section 6104(d)). An organization must make its three most recent annual filings available or face penalty taxes.
- Failure to make the organization’s application for tax status determination (and all related documents) available for public inspection or to provide a copy of the application materials (Section 6104(d)). This requirement applies to organizations that filed their applications for exempt status on or after July 15, 1987, and to organizations that had a copy of their applications on hand on this date.
- Illegal use of funds for political campaigns (Section 4955).
- Excessive use of funds for lobbying purposes (Section 4912).

Question 8: What are some examples of actual lawsuits or other actions against foundations and/or foundation managers?

In addition to the actions by the IRS noted above, there are occasional lawsuits brought against foundations. However, lawsuits for personal injury or damage to property are very rare since foundations normally provide no direct services. They generally do not run hospitals, supervise swimming pools or maintain motor vehicles to provide transportation. Public charities that are direct service providers are much more vulnerable to this kind of suit.

According to insurance industry sources, most lawsuits filed against private foundations and public charities are employment-related. Employees—or, more frequently, former employees—may contend that they have been unfairly fired or that they did not receive promotions to which they were entitled. They may claim that they were discriminated against on the basis of their sex, race or age. Generally, the more employees that an organization has, the more it is at risk for such a lawsuit.

The following is a typical employment-related lawsuit and its outcome:

A former employee filed a claim against a private foundation for discrimination because she was terminated while she was on maternity leave. Although she was terminated during a reduction in force (RIF) that affected other employees, the foundation did not have any documentation as to why she was being terminated instead of other employees who were not terminated during the RIF—and who were not out on maternity leave. In the absence of any documentation or explicit reason as to why this particular employee was terminated, the insurance company opted to settle the case by paying the former employee \$26,000. Claim expenses for this matter were approximately \$22,000.

Another source of lawsuits is state attorneys general. Acting in their roles as protectors of charitable funds and beneficiaries, attorneys general may file suits that allege mismanagement of assets or other derelictions of fiduciary duties. While there is no statistical evidence of any recent increase in the frequency of lawsuits filed against foundations, attorneys general in many states are becoming more aggressive in overseeing the charitable community.

Finally, some foundations become embroiled in litigation as a result of internal disputes. Disagreements among board members and family feuds that spill over into foundation management conflicts can turn into lawsuits.

The following are examples of actual cases or actions against foundations:

- A private foundation in California awarded a one-year, \$1 million grant to a health clinic. The grant agreement noted that funding would be renewed at the sole discretion of the foundation. At the end of the year, just over half of the funding was disbursed and the foundation had decided that its funding priorities would not include projects like the grantee's. The parties executed an agreement under which the grantee would receive the balance of the grant, and the money was paid out. After receiving the funds, the grantee sued the foundation and claimed that discussions that preceded the first grant agreement entitled it to \$4.5 million over three years. A jury agreed and awarded the grantee \$2 million. In 1999, the California Court of Appeal reversed the verdict.
- A donor established a designated fund for a particular organization by a bequest to a community trust. Over the years, societal changes led to changes in the operations of the organization. The community foundation exercised its variance power and ended the annual distributions to the organization. Many years later, the organization sued the community foundation and the individual members of the foundation's board, claiming that it was entitled to distributions from the designated fund. The appeals court found in favor of the community foundation.

- In 2000, some directors of a foundation that operated an art museum in Chicago sued the foundation and some of its directors. They alleged mismanagement as well as a plot by some directors to move the foundation's art collection from Chicago to Washington, DC. The Illinois attorney general intervened and, after lengthy litigation and mediation, the foundation underwent a change of management and made a long-term commitment to Illinois.
- In 2002, residents of a community sued a foundation that had explored the possibility of setting up a grant program to reduce poverty in the area. The plaintiffs claimed that in the process of involving the community in the planning process the foundation had made binding promises to provide funding. The U.S. District Court dismissed the claim. In 2005, a federal appeals court reinstated part of the claim. It found that the foundation had made no binding promise to the community regarding the grant funding but had possibly committed itself to paying the expenses of those who participated in the planning process.
- In the 1970's, a private foundation provided a grant for architectural services and construction of a downtown park on land owned by a city. In subsequent years the foundation responded to occasional requests from the city for assistance with extraordinary maintenance, renovation, and improvements to the park and surrounding area. When visitors to the park died in 2004, the visitors' families sued the city, foundation, and other parties involved in design, construction, and maintenance of the park since inception. Although all claims against the foundation were dismissed by the court, the foundation was forced to incur significant legal costs in defending itself through the course of discovery, depositions, and motions brought before the court.
- In Texas, the sister of a foundation executive (who, like the executive, was a grandchild of the foundation's donors) became suspicious about the organization's operations. Her investigation led to a suit by the attorney general and the removal of the foundation's executive, some of his colleagues and members of the board. In 2004 a jury ordered two of the foundation's executives to repay over \$20 million to the foundation.

Here are some older examples of litigation involving foundations:

- In 1972, a man in Buffalo, New York, brought suit against 14 Buffalo foundations (private and community) alleging that his children had been denied scholarship assistance, that he had been denied employment because of his race and that the foundations had refused to grant money to his foundation on racial grounds. Four years later the case was dismissed, with defense costs estimated to have exceeded \$100,000.
- One trustee of a midwestern private foundation sued several fellow trustees on charges including mismanagement and excessive payment of fees. The suits were eventually dismissed.

- The attorney general in New York brought action against a private foundation for allegedly selling an undervalued asset in order to produce greater income for grantmaking. The asset was sold at a price much higher than its value on the foundation's books.
- The attorney general in California brought action against the trustees of a private foundation requiring that excessive trustee fees be repaid to the foundation. The fees were repaid.
- The attorney general in Texas brought action to compel changes in the composition of the board of a private foundation following the revelation of millions of dollars having been spent on developing a theme park that had never been opened to the public. It had been used to house horses belonging to members of the board. The board members were replaced.
- The original founding documents of a private foundation in the midwest specified that a portion of the income from the endowment go to a particular charitable organization. The named charity brought suit against the foundation claiming mismanagement of foundation assets. [return to main text]

In many cases, including some of those just described, a foundation may be successful in its defense or may not be required to take action necessitating a financial outlay. An employee's claim of discrimination may be dismissed, the attorney general's charges may turn out to be baseless, or the management conflict may be resolved. However, in making the successful defense or negotiating the final resolution, considerable legal expenses may be incurred. Can the foundation manager afford to pay his or her defense costs? Can the foundation afford to pay its defense costs? Can the foundation afford to reimburse the director or officer for his or her defense costs? The goal of this paper is to design a system in which the foundation and the director will be adequately protected should such a defense become necessary.

Part II

Indemnification

Question 9: **What is indemnification?**

“Indemnification” and “to indemnify” are legal terms meaning to pay the costs of another, or to reimburse another person for costs incurred. In the nonprofit context, the purpose of indemnification is specifically to provide financial protection to an officer or director in case actual or threatened legal proceedings arise from the action or omission of the director or officer in the course of his or her service to the organization.

In short, the organization pays the legal costs, expenses, judgments and settlements of the director. The obvious rationale for providing indemnification protection is to persuade responsible persons to serve on the board of the organization with less fear that they will personally have to bear the costs to defend their actions. These costs can be high. Reportedly, the average cost of defending a discrimination in employment action is \$116,000. It is certainly not unrealistic to expect a serious lawsuit to cost well over that amount.

However, this promise of indemnification is not very comforting if the organization has very few assets and, therefore, could not cover such costs. For smaller charities, indemnification may not solve any problems. For foundations and other organizations with sizable endowments or reserves, indemnification will provide a much more realistic form of protection.

Question 10: What risks can be covered by indemnification and what risks cannot?

The answer to this question is not straightforward; it depends on state law. Because the precise extent of permissible coverage will vary from state to state, this question is best directed to the organization's legal counsel. Moreover, several states (Delaware and Pennsylvania, for example) have amended their indemnification statutes to provide a broader scope for what may be indemnified. The liberalization of these statutes is a direct response to past liability crises.

Not all states have modernized their indemnification laws. For example, several states have statutes still based on the 1964 Model Nonprofit Corporation Act, which has serious shortcomings. For example, these statutes: 1) exclude coverage for threatened litigation; 2) only permit (do not require) the nonprofit to reimburse the director (even if he or she successfully defends the lawsuit); 3) cover only the costs of defense and not the costs of judgments, fines or settlements; and 4) are unclear about coverage of investigative or administrative proceedings.

Fortunately, most states have taken a more contemporary approach where the director has a right to indemnification when he or she is successful in his or her defense of the lawsuit. This right may be enforced in court and is sometimes referred to as *mandatory indemnification*.

However, when the case is lost or settled, the right to reimbursement is not absolute. This is called *permissive indemnification*. Under these circumstances, the organization must make a decision whether or not to indemnify in accordance with the procedures set out in the state law. A plan to indemnify may be spelled out ahead of time in the charter, the bylaws, or the board policy. Similarly, after the costs are incurred, the board may vote to reimburse. In some circumstances, even if the board has not made such a decision, the director may go to court seeking an order requiring reimbursement.

Generally speaking, indemnification—whether mandatory or permissive—covers the legal expenses in any suit brought against a director, so long as the director was acting in good faith and in the best interests of the corporation. The precise standard of care required for eligibility will vary from state to state depending on the type of suit. But if the standard is met, virtually all the risks noted in questions one and two will be covered, subject to whatever limitations may be spelled out in the applicable state statute.

For example, most state indemnification laws are more generous to directors in "third party" suits, and much more restrictive in "derivative type" suits. A third party suit is normally brought by someone who is not a director, officer or member of the corporation; these actions involve efforts to assert that the foundation has violated the third party's rights. Examples would be a citizen suing for libel, an ex-employee suing for wrongful termination or a vendor suing for breach of contract. Derivative type suits involve efforts to assert that someone has violated the rights of the corporation itself. Typically, one board member, on behalf of the corporation, sues another board member based on a violation of one of the fiduciary duties owed by the board member to the corporation. Most

actions brought by the state attorney general relating to the fiduciary duties owed to the corporation by the directors are considered derivative-type actions.

Under most state statutes, indemnification in derivative type actions is permitted only for defense costs where the director is successful. In third party actions, the costs of judgments, settlements and expenses of defense may also be covered even if the director is not successful. This limitation on derivative type actions is only sensible. It would not make sense to compel a director to pay back an unlawful loan (self dealing) only to have the corporation, once reimbursed, turn around and indemnify the director by returning the money.

In some states indemnification may not be permissible even when the director is successful in his or her defense. For example, some states require court approval of any expenses involving any kind of derivativetype suit.

In summary, indemnification does not protect the foundation at all. In fact, it obligates the foundation to reimburse its officers and directors for legal expenses incurred. Depending on the state, the degree of indemnification permitted will vary. Whether or not the directors of the foundation will feel adequately comfortable with indemnification alone will depend on the extent of coverage permitted and the size of the reserves or endowment available to make the payments.

Question 11: **How does a foundation provide for indemnification?**

Again, because state laws differ with respect to indemnification, no single answer is universally accurate here, and each organization should consult its legal counsel for guidance, especially because some states have recently revised their statutes.

Even in those states where mandatory indemnification allows the director to sue in court for reimbursement, it is strongly advisable for the foundation to document in writing its commitment to indemnifying its directors. Usually, this commitment is spelled out in the bylaws, but, depending on state requirements, it could be stated in the articles of incorporation or in a board resolution (some organizations even enter into individual written contracts with each director). Because statutes change and the law evolves, it is often wise to state clearly that the foundation intends to indemnify its directors to the fullest extent permitted by law.

Usually, these written commitments are fairly long, spelling out the standards that must be met for a director to be eligible for indemnification. Where indemnification is permissive, the statement will usually provide a procedure whereby the disinterested members of the board can make an independent judgment approving indemnification. If too many members of the board are involved, the procedure may call for a decision by a specially appointed legal counsel. Where the state statute permits the corporation to advance the costs of litigation as they occur, it is wise to include such permission in the written statement. When advancing costs is permitted, the statute usually requires the director to promise to repay the advances if he or she is determined ultimately to be ineligible.

Question 12: Don't state laws make directors of nonprofit organizations immune from liability?

Many states have laws that provide immunity from liability for nonprofit directors under certain circumstances. However, directors of nonprofits who believe they are free from all potential obligations are mistaken. There are several reasons to be wary:

- The statutes often apply only to volunteer directors; for foundation directors who are compensated, there is no immunity.
- Each statute includes exceptions. For example, the law may provide immunity from liability so long as the director did not act “wantonly” or “with gross negligence.” *Remember, immunity from liability is not immunity from being sued.* The director may never be found liable, but the lawsuit must still be defended. It is relatively easy for the injured party’s lawyer simply to amend the lawsuit and allege “gross negligence” rather than simple negligence. The burden of proof may be higher for the plaintiff, but the cost of defending the suit may still be staggering.
- Many of these statutes apply only to claims involving personal injury or property damage. For all other claims (see question two), these immunity provisions would not apply.
- None of these statutes has been tested in the courts, and the insurance industry—while optimistic—is adopting a “wait and see” attitude.

Part III

Directors and Officers Liability Insurance

Question 13: **What is D&O insurance?**

Unlike general liability insurance (see question one), D&O insurance excludes claims arising from bodily injury or property damage. As noted earlier, each of these types of insurance (general liability and D&O) usually excludes what the other covers. It is also a fair generalization to say that D&O insurance is essentially mismanagement coverage, designed to pay the associated attorney fees and court costs arising from covered perils. When one excludes actions for bodily injury and property damage, the number of cases brought against nonprofits is very limited. Moreover, nonprofits usually win or reach a settlement. But in the process of winning, settling or defending, legal costs can become very heavy.

The typical D&O policy protects against damages resulting from a “wrongful act,” which is normally defined as “any breach of duty, neglect, error, misstatement, misleading statement, omission, or other act(s) done or wrongfully attempted.” For a review of the types of actions not involving bodily injury or property damage which may be brought against an organization, see question two.

Question 14: **Who is covered by D&O insurance?**

Different types of D&O policies cover different people. The most limited type of D&O policy covers only the directors and officers, not the foundation. An “association-type” policy offers the broadest coverage. It will generally cover officers and directors, the foundation itself (i.e. entity coverage), employees, trustees, volunteers and committee members. Association-type coverage can sometimes protect the foundation’s assets by paying legal expenses upfront (see question 20). It also obligates the insurer to appoint qualified legal counsel if the foundation is sued. This type of policy provides protection to people who are not officers and directors and may help encourage volunteers to aid the foundation.

A note of caution: some policies will appear to cover the directors, officers and the foundation itself. However, when read more closely, the section covering the foundation will simply state that the policy will reimburse the foundation only

for any payments the foundation is obligated to make to indemnify its officers and directors. Therefore, such a policy does not cover the foundation, and the legal expenses of a lawsuit against the foundation would not be reimbursed. It is important to verify that a particular policy offers association-type coverage, as insurance brokers and agents may not make this point clear.

**Question 15: Which areas are covered by D&O insurance and which are not?
How does D&O insurance differ from indemnification?**

While D&O insurance excludes coverage for bodily injury and property damage, directors could possibly be indemnified for such claims depending upon the particular circumstances and how the suit is worded. In these cases, however, the foundation's general liability insurance policy normally covers claims against the foundation and against the foundation manager. The important differences between D&O insurance and indemnification relate to claims other than those involving bodily injury and property damage.

Again, it is hard to generalize here since state indemnification laws are different and D&O insurance policies vary. Nevertheless, unlike a typical D&O policy, indemnification will cover the following areas: 1) criminal charges, so long as the director had no reasonable cause to believe his or her conduct was unlawful; 2) fines and penalties in direct, third party actions (but see question 19); 3) punitive damages in third party actions; and 4) the expenses for defense in investigative matters.

Barring the exceptions just noted, D&O insurance will normally cover everything that indemnification covers (but see the list of exclusions below). However, if the foundation can obtain a broad "association type" D&O policy, coverage will not be limited just to directors and officers, but will include the foundation itself, employees, committee members and volunteers. In this case, D&O insurance is much broader because of whom it covers, not what it covers.

Some actions are excluded by all D&O policies; exclusion of others depends upon the particular policy.

Always Excluded:

- bodily injury and property damage
- intentional and dishonest acts
- criminal acts
- violations of state laws resulting in fines or penalties
- pollution and nuclear waste.

Frequently Excluded:

- libel, slander and false imprisonment
- employment discrimination or wrongful termination
- cases involving insured-against-insured actions (i.e., one director suing another)
- failure to maintain proper insurance
- punitive damages.

Question 16: If actual lawsuits are so rare, is D&O insurance really necessary?

While it is true that very few claims have been successfully tried against foundations, the likelihood of a lawsuit continues to increase. Even the most frivolous, spurious suit must be defended, and the legal and court costs of defense can be very high. In addition, state regulators (attorneys general) are beginning to take a more serious look at their duties to protect the public and to insist on the proper exercise of fiduciary responsibilities by directors.

While offices rarely burn down and visitors do not often slip on banana peels, most organizations would not think of doing business without general liability and fire insurance. Similarly, D&O insurance is purchased to protect against the unlikely but costly possibility of a claim. It is also worth noting that there is a growing tendency on the part of individuals contemplating service on the board of directors of a foundation to request such insurance as a condition of service.

Question 17: How should a foundation decide whether to obtain D&O insurance?

It is very hard to draw the line between the foundations that really should have D&O coverage and those that should not. Obviously, the larger your organization—the more staff members you have, the more grants you make, the more controversial your grants, the more investments you have, the more contracts you enter into—the greater your exposure to potential claims. Foundations with no office, no staff, no contracts, few grants and limited investments may feel the chance of a claim to be so remote that the cost of D&O insurance may not be warranted.

The cost of insurance is also an important factor. If a \$1 million policy were to cost \$10 per year, everyone would buy it; but, if the cost were \$150,000 per year, one could well argue that it would be cheaper in the long run simply to provide indemnification.

Any foundation or other charity with a large endowment has “deep pockets” and is automatically an attractive target for an injured party’s lawyer to pursue. The foundation may have enough assets available to protect the director through indemnification, but the prudent director should be interested in protecting the endowment as well. If an association-type policy is available at a reasonable price, it may well be worth obtaining.

Each foundation, in consultation with its legal advisors and others who may help in assessing risks, must examine its own circumstances, assess its potential for liability, research the availability of D&O insurance and carefully examine the costs of coverage in light of the risks.

The twelfth edition of the Council’s Foundation Management Series (2004 data) indicates that for non corporate foundations with over \$10 million in assets, 88 percent of respondents now carry D&O insurance, a substantial increase from 62 percent in the 1990 survey.

Question 18: Why not simply provide for each director to be covered by his or her personal umbrella policy?

Most individuals can purchase a broad umbrella policy on top of their general home insurance policy. In some cases, it is possible to include in such a policy coverage for liabilities arising from actions involving service on boards of directors. Unfortunately, these policies are generally limited to actions involving bodily injury and property damage and, therefore, can in no way substitute for a D&O policy. Moreover, this option offers no protection for the organization, and since the vast majority of suits name the foundation this is a potentially significant gap. In addition, foundation board members and volunteers may be reluctant to put their own insurance policies at risk in connection with their foundation work. Finally, salaried employees and board members receiving any compensation for their service would most likely not be afforded coverage.

Question 19: How much D&O coverage is needed?

Simple rules of thumb are almost impossible to provide. There is such an enormous variety in the type of foundation (even among those that are the same size) that generalizing here is not particularly useful. However, it may help you to compare your foundation with others. Data from the Council's Foundation Management Series can be helpful in giving you and your advisors a sense of what other similarly situated foundations have chosen.

Most foundations who purchase D&O insurance obtain coverage for between \$1 million and \$5 million. Note that these amounts are typically a factor of how much coverage insurance companies will offer and of the premium cost. If higher limits were available at reasonable prices, foundations might purchase greater coverage.

Question 20: What are the important provisions to look for in a good D&O policy? What are some of the pitfalls to avoid?

While most D&O policies follow a similar format, there are certain features that are well worth looking for and understanding before you choose a company. Obviously, the price of insurance and reputation of the company are important. Also, as noted in question 12, a broad association type policy is preferable to a straight D&O policy where coverage is limited just to directors and officers. Here are some other issues to keep in mind:

"Claims made" versus "occurrence" policy method

Virtually all D&O policies today are "claims made" policies, which is a relatively new, innovative insurance method covering losses from claims asserted against the insured during the policy period, regardless of whether the liability imposing causes occurred during or prior to the policy period. The traditional "occurrence" liability insurance method, on the other hand, provides coverage for

losses from liability imposing causes which occurred during the policy period regardless of when the claim is asserted. With an occurrence liability policy, once the policy period is over, the extent of the underwriter's liability is not known, and the underwriter may not discover for years the extent of liability from losses claimed to have occurred within the policy period. On the contrary, with a claims made policy, the extent of the underwriter's liability is clear when the policy ends.

“Duty to defend” versus “legally obligated”

Some policies state that the company will pay on behalf of the insured all losses which the insured “shall become legally obligated to pay.” Technically, this could mean that the company does not have to pay until the manager or the foundation has lost or settled the case. The case could continue for years and require a heavy outlay by the foundation or the manager before reimbursement by the company.

Other companies use the phrase “duty to defend” which suggests that they have a responsibility to pay the expenses as they occur. In fact, this comparison may be a distinction without a difference, because companies that use the phrase “shall become legally obligated to pay” are not likely to sit by and watch legal costs rise which they may have to pay later. It is crucial that the foundation obtain a clear understanding (preferably in writing) of the company's policy once a claim arises (i.e., when does reimbursement of costs begin?). In general, use of the term “duty to defend” in the policy is preferable.

Control over choice of counsel

Some policies give the company the sole right to appoint or choose counsel. Others provide that choice of counsel shall be “mutually agreed upon by the insured and the company.” Having a voice and control over counsel can be helpful, especially if the foundation has a longstanding relationship with an attorney or firm that could handle the foundation's defense. Remember that it is in the insurance company's interest to have a lawyer who will effectively defend the insured foundation and minimize both legal fees and payouts to plaintiffs.

Protection of managers from false statements made by other managers

In applying for D&O insurance, a written application must be completed, with certain declarations and statements upon which the company relies to issue the policy (including statements about knowledge of circumstances that might give rise to liability). Your policy should have a “severability” or “warranty and severability” clause, which assures that in case one or more managers make false statements on the application, the policy would only be void for those managers but still hold for managers who did not make any false statements. Without such a clause, if one manager makes a false statement on the application, the insurance could be void for all managers.

“Discovery period” in case of cancellation

If for any reason your D&O policy is cancelled or not renewed, it may take time to arrange for new coverage. That time gap may leave you vulnerable, so it is important to have a “discovery period” clause in your policy to extend your protection. A discovery period is a length of time after cancellation of an insurance contract that allows the insured to discover any losses that would have been covered if the contract had remained in force. Usually, this additional period is 12 months from the date of cancellation. If a wrongful act occurring prior to cancellation is discovered during that time, the clause will cover your liability. The additional cost for this 12 month discovery period is usually 25 percent of the premium, but it could be higher.

“Definition of loss” and “exclusions”

At the heart of every D&O policy are two sections: the “definition of loss” and the “exclusions” from that definition. Often the standard language of the policy will be amended by endorsements that are added at the end of the policy. These are sometimes called riders. To determine exactly what a policy does and does not cover, examine the definition of loss, the list of exclusions and any endorsements or riders that are added. Generally speaking, unless you have received a direct price quote for the policy, you are probably not looking at the complete contract. Therefore, it is wise to obtain quotes and complete contracts before comparing companies in detail.

Question 21: Do D&O policies cover the Chapter 42 penalties that private foundation managers can be subject to?

There are only three cases under Chapter 42, (see question four), where individual foundation managers may be subject to a penalty tax: self dealing, jeopardy investments and taxable expenditures. In each case, there is no violation unless the manager acted knowingly, willfully and without reasonable cause. State laws, however, do not permit insurance companies to insure persons for knowingly and willfully violating the law. Therefore, the insurance company *cannot* pay the tax. However, the insurance company *can* pay the costs of defense, whether successful or unsuccessful. Since many claims are successfully defended and most claims are settled, insurance coverage to pay the costs of defense and settlement is very valuable.

Because of the complexity of Chapter 42 and other tax code violations, many insurance companies do not fully understand it. Normally a company will provide a standard D&O policy and add a special rider to cover these violations. You must examine such a rider carefully to make sure it provides the coverage you need. On occasion, such a rider will limit protection for Chapter 42 violations to actions where the manager relied upon the written opinion of counsel.

Unfortunately, this makes the rider virtually useless. If a manager relies on the written opinion of counsel, Treasury regulations conclude that there is reasonable cause for his or her actions. Therefore, there can be no violation and thus no penalty tax. In short, this kind of rider insures you only for cases where there can be no liability.

Part IV

Correct Tax Treatment of Insurance Premiums

Question 22; **If a private foundation or public charity purchases D&O insurance for a manager, does the manager have to include the amount of the premium in his or her taxable income?**

No. Under regulations instated in 1992 (and reprinted at page 35 of the Appendix), D&O premiums that a foundation pays on behalf of its managers are not taxable income. Instead, they are considered “working condition fringe benefits” under IRC Section 132. Private foundations and other tax-exempt organizations “need not allocate portions of D&O insurance premiums to individual directors and officers or include such allocable amounts in Form 1099 or W2.” This favorable treatment is available regardless of whether the foundation manager receives any compensation for his or her services.

Question 23: **If a private foundation or public charity makes an indemnification payment to a manager, must the manager include the payment in his or her taxable income?**

No. Under the 1992 regulations, indemnification payments are to be treated in the same way as D&O insurance premiums—as “working condition fringe” benefits under IRC Section 132. Accordingly, they are not taxable income to the manager.

Question 24: **Must indemnification payments and/or payments for D&O insurance be included in total compensation for the purpose of determining whether a private foundation manager’s compensation is reasonable?**

Only certain, small portions of a foundation’s insurance premiums—and only certain indemnification payments—need to be included in a foundation manager’s compensation package for the purposes of determining whether his or her compensation is reasonable or excessive. The portion of a foundation’s D&O premium payment that must be treated as compensation may in many cases be so small that it does not need to be accounted for.

The private foundation rules bar as self-dealing certain financial transactions between foundations and certain foundation insiders, including trustees, directors, major donors and certain members of these individuals' families. One of the barred financial transactions is the transfer of income or assets of the foundation to or for the benefit of one of these disqualified persons. In theory, paying a premium for a D&O policy or making an indemnification payment to a disqualified person could be considered an act of self-dealing.

However, an exception to the self-dealing rules and clarifying regulations issued by the Treasury makes this outcome unlikely. This exception stipulates that a foundation may pay compensation to a disqualified person so long as the compensation is for personal services that are necessary to the foundation's mission and so long as the compensation is reasonable in amount. To determine whether the compensation is reasonable, it must be calculated in total and compared to what others are receiving for similar work at similarly situated organizations.

In most cases, it seems unlikely that adding the value of a D&O premium to any individual's compensation package would push him or her over the line between reasonable and excessive compensation. In the 1990s, the Council's concern was that private foundations would run up accounting and legal bills allocating these relatively tiny sums to the relevant officers and directors. Accordingly, the Council sought and secured a set of 1995 regulations (reprinted at page 41 of the Appendix).

The regulations aim to discourage foundations from relieving managers of liability for penalties by allowing, for the purpose of the self-dealing rules, inclusion in compensation the part of any insurance premiums or indemnification payments that cover penalties and expenses not reasonably incurred as compensatory. On the other hand, any parts of a premium or indemnification for expenses that are "reasonably incurred in proceedings that do not result from a willful act or omission of the foundation manager undertaken without reasonable cause" are considered non-compensatory; these expenses are viewed as expenses of foundation administration and not subject to the self-dealing rules.

The regulations treat the following as compensatory: coverages (or indemnification payments); payments for taxes (including foundation penalty taxes); penalties; expenses of correction; any expenses not reasonably incurred by the foundation manager in connection with a civil judicial or civil administrative proceeding arising out of the manager's performance of services on behalf of the foundation; and any expenses resulting from an act or failure to act with respect to which the manager has acted willfully and without reasonable cause.

In follow-up discussion, Treasury staff suggested that, depending on the amount involved, the compensatory portion of an allocated premium payment might be considered *de minimis*—so small as to make accounting for it unreasonable or administratively impractical.

It may be helpful to secure a letter from the insurance provider confirming that the total value of the "compensatory" coverages is indeed *de minimis*.

Note that the regulations classify indemnification payments to foundation managers as compensatory or non-compensatory payments in the same way

they do premium payments, whether they are payments of expenses already incurred or payments in anticipation of future expenses. Furthermore, direct payments of such expenses that a foundation makes on behalf of managers will also be subject to this classification system.

Question 25: The Intermediate Sanctions (Tax Code Section 4958) that apply to public charities also prohibit excessive compensation for charity managers. Must managers include the allocable portion of D&O premiums or indemnification payments made to or for them as part of their compensation package?

Yes. The regulations that accompany the Intermediate Sanctions provide that a public charity must include in its calculation of an individual's total compensation any payment of "liability insurance premiums for, or the payment or reimbursement by the organization of: (i) any penalty, tax, or expenses of correction owed under section 4958; (ii) any expense not reasonably incurred by the person in connection with a civil judicial or civil administrative proceeding arising out of the person's performance of services on behalf of the applicable tax-exempt organization; or (iii) any expense resulting from an act or failure to act with respect to which the person has acted willfully and without reasonable cause," unless the amount is a de minimis fringe benefit (Treas. Reg. §53.4958-4(b)(1)(ii)(B)(2)).

Like the private foundation rules, this provision seeks to discourage public charities from covering expenses when a person breaks the rules; any premiums or indemnification payments that a public charity makes that would pay for penalties or expenses incurred because the relevant person has acted willfully and without reasonable cause will be treated as compensation. On the other hand, any parts of a premium or indemnifications for expenses that are reasonably incurred in proceedings that do not result from a willful act or omission of the manager undertaken without reasonable cause should generally be considered non-compensatory; these expenses are viewed as expenses of foundation administration.

Part V

How to Minimize Your Risks

Question 26: **What steps can a foundation take to reduce the potential liability of its board members?**

The best way for board members to protect themselves from potential liability is to make sure that they carry out their responsibilities to the foundation and take the time to ensure that the foundation has strong management systems in place. Good risk management includes education of board members and staff and development of procedures for handling situations in which liabilities may arise.

We have mentioned fiduciary duties in various parts of this pamphlet and it is important that all board members understand what it means to be a fiduciary of a charitable organization. The word fiduciary comes from the Latin word for “faith”, and indeed a fiduciary is someone in whom faith is placed and from whom good faith is expected. Defined most broadly, a fiduciary is someone (or some institution) that bears a special responsibility or trust for someone else. Under the laws that govern charitable organizations throughout the country, fiduciaries generally have two major duties: *a duty of care*, which requires them to discharge their duties for the benefit of the organization in good faith and with the degree of care that a prudent person would bring to such tasks; and a *duty of loyalty*, which requires them to deal fairly with the charity, especially where a potential conflict of interest may exist. These duties and other responsibilities of board members are discussed in the Herman and White article, “D&O: What You Need to Know,” along with strategies designed to minimize liability exposure.

Board decisionmaking is an area of critical importance. Governmental investigators and factfinders (the IRS, attorneys general and judges) may seek to impose liability on board members for decisions that have gone awry. They will necessarily examine the decisionmaking process of the board to determine whether the board members met fiduciary standards. Did the directors possess sufficient information concerning the decision? Did the directors critically examine the information that was available to them? Did the directors take enough

time to make an informed decision? To make sure that these questions can be answered positively in these and other situations, board members should:

- A. Attend all (or most) of the board meetings and meetings of committees on which they sit. If they cannot attend meetings, they should not become board members.
- B. Review the bylaws to ensure they are in compliance with the state statute governing nonprofit corporations; include legal counsel in this review.
- C. Make certain that bylaws are enforced; actions taken in violation of state laws or established bylaws may be successfully challenged in court.
- D. Insist on advance notice to directors of any major item of business to be acted upon at the next meeting.
- E. Request written materials of directors in advance of the board meeting at which the action is to be taken.
- F. Read financial statements, budget proposals and other reports.
- G. Question such reports when obvious inconsistencies or problems appear.
- H. Take steps to investigate and rectify problems.
- I. Use expert advice to supplement their understanding and experience when dealing with complex matters.
- J. Insure that accurate, thorough records are kept of the decisions made by the board and of the process for reaching those decisions; record discussions and votes, particularly on controversial or divisive topics.
- K. Adopt a written conflict of interest policy that conforms with state statutes.
- L. Be certain that the purpose of the organization as established in the founding documents is clear and followed

Here are some additional resources that may be helpful for educating board members about their responsibilities and in implementing systems that reduce exposure to liability.

M. Herman and L. White, *D&O: What You Need to Know* (Washington, D.C.: Nonprofit Risk Management Center), 1998. Available for purchase at www.nonprofitRISK.org.

<http://cof.npo-ins.com/riskman.jsp?subd=cof> This section of the Council's website discusses the endorsed D&O insurance program and offers a variety of risk management tools, including an article on employee handbooks and a glossary of risk management terms.

<http://www.boardsource.org> BoardSource is an organization committed to building effective nonprofit boards. Their resources include publications on all aspects of governance.

<http://www.cof.org/safeguarding> This information packet contains articles on conflicts of interest as well as sample policies for different types of grant-makers.

Appendix

Insurance, by Grantmaker Type and Asset Group, 2004

Table 4.1. Percentage and Number of Grantmakers That Provide Directors and Officers Liability

Grantmaker Type and Asset Group (in millions)	Percent that Provide Directors and Officers Insurance	Number that Provide Directors and Officers Insurance	Number of Respondents
Community			
\$500 or more	100.0	8	8
\$250 to \$499.9	94.1	16	17
\$100 to \$249.9	100.0	25	25
\$50 to \$99.9	89.7	26	29
\$25 to \$49.9	97.8	44	45
\$10 to \$24.9	87.9	51	58
\$5 to \$9.9	86.1	31	36
Less than \$5	64.5	20	31
All	88.8	221	249
Family			
\$500 or more	100.0	6	6
\$250 to \$499.9	85.7	6	7
\$100 to \$249.9	86.4	19	22
\$50 to \$99.9	84.2	16	19
\$25 to \$49.9	65.2	15	23
\$10 to \$24.9	43.6	17	39
\$5 to \$9.9	46.7	7	15
Less than \$5	20.0	5	25
All	58.3	91	156
Independent			
\$500 or more	93.3	28	30
\$250 to \$499.9	100.0	18	18
\$100 to \$249.9	95.0	38	40
\$50 to \$99.9	93.3	28	30
\$25 to \$49.9	90.5	19	21
\$10 to \$24.9	89.5	17	19
\$5 to \$9.9	70.0	7	10
Less than \$5	75.0	6	8
All	91.5	161	176
Public			
\$250 or more	100.0	3	3
\$100 to \$249.9	100.0	11	11
\$50 to \$99.9	100.0	10	10
\$25 to \$49.9	100.0	9	9
\$10 to \$24.9	100.0	7	7
\$5 to \$9.9	80.0	4	5
Less than \$5	100.0	7	7
All	98.1	51	52
All			
\$500 or more	95.7	44	46
\$250 to \$499.9	95.3	41	43
\$100 to \$249.9	94.9	93	98
\$50 to \$99.9	90.9	80	88
\$25 to \$49.9	88.8	87	98
\$10 to \$24.9	74.8	92	123
\$5 to \$9.9	74.2	49	66
Less than \$5	53.5	38	71
All	82.8	524	633

Table 4.2. Of Those Grantmakers That Provide Directors and Officers Liability Insurance, the Percentage and Number for Which There Is a Deductible, by Grantmaker Type, 2004

Grantmaker Type	Percent with a Deductible	Number with a Deductible	Number of Respondents
Community	73.1	128	175
Family	82.2	60	73
Independent	81.6	115	141
Public	78.9	30	38
All	78.0	333	427

Table 4.3. Annual Deductible on Directors and Officers Liability Insurance, by Asset Group, 2004

Asset Group (in millions)	Median	Mean	Range	Number of Respondents
\$500 or more	25,000	60,294	5,000 to 250,000	34
\$250 to \$499.9	10,000	29,569	2,500 to 200,000	29
\$100 to \$249.9	5,000	12,341	1,000 to 100,000	63
\$50 to \$99.9	4,250	8,370	500 to 50,000	50
\$25 to \$49.9	2,500	7,971	500 to 50,000	52
\$10 to \$24.9	2,500	3,051	500 to 10,000	40
\$5 to \$9.9	1,125	3,102	500 to 25,000	22
Less than \$5	2,500	4,413	500 to 50,000	23
All	5,000	15,367	500 to 250,000	313

Table 4.4. Liability Limit on Directors and Officers Liability Insurance, by Asset Group, 2004

Asset Group (in millions)	Median	Mean	Range	Number of Respondents
\$500 or more	10,000,000	10,571,429	1,000,000 to 25,000,000	42
\$250 to \$499.9	5,000,000	5,666,667	1,000,000 to 15,000,000	39
\$100 to \$249.9	5,000,000	4,081,395	1,000,000 to 10,000,000	86
\$50 to \$99.9	3,000,000	3,618,056	500,000 to 15,000,000	72
\$25 to \$49.9	2,000,000	2,400,000	1,000,000 to 10,000,000	70
\$10 to \$24.9	1,000,000	2,156,338	100,000 to 10,000,000	71
\$5 to \$9.9	1,000,000	1,813,953	1,000,000 to 10,000,000	43
Less than \$5	1,000,000	1,400,000	100,000 to 10,000,000	29
All	2,000,000	3,796,903	100,000 to 25,000,000	452

Table 4.5. Annual Premium on Directors and Officers Liability Insurance, by Asset Group, 2004

Asset Group (in millions)	Median	Mean	Range	Number of Respondents
\$500 or more	27,300	41,407	9,375 to 125,000	33
\$250 to \$499.9	12,689	19,334	3,308 to 74,437	30
\$100 to \$249.9	7,455	9,324	1,484 to 57,337	67
\$50 to \$99.9	6,077	7,273	750 to 47,629	60
\$25 to \$49.9	3,282	3,908	609 to 16,695	58
\$10 to \$24.9	2,095	2,696	76 to 25,000	55
\$5 to \$9.9	1,500	1,692	350 to 4,130	32
Less than \$5	1,100	2,482	340 to 27,800	19
All	4,410	9,841	76 to 125,000	354

Table 4.6. Median, Mean and Range of the Annual Premium on Directors and Officers Liability Insurance, for Selected Liability Limits, 2004

Liability Limit		Annual Premium			Number of Respondents
Amount	Number	Median	Mean	Range	
\$1,000,000	157	2,042	2,676	340 to 16,000	125
\$2,000,000	71	2,900	3,945	740 to 16,000	53
\$3,000,000	44	4,919	7,012	1,250 to 57,337	40
\$5,000,000	115	8,823	10,877	2,100 to 44,791	85
\$10,000,000	44	23,988	30,827	5,000 to 125,000	32

Note: 452 respondents provided data on liability limits (Table 4.4), 431 of those had a liability limit in one of the five amounts listed above. Of the 431, 335 provided data on the annual premium.

December 30, 1992 Treasury Regulations

Dated: December 16, 1992.
Arthur J. Hill,
*Assistant Secretary for Housing—Federal
Housing Commissioner.*
[FR Doc. 92-31480 Filed 12-29-92; 8:45 am]
BILLING CODE 4210-27-M

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1
[T.D. 8457]
RIN 1545-AP74

**Taxation of Fringe Benefits and
Exclusions From Gross Income of
Certain Fringe Benefits**

AGENCY: Internal Revenue Service,
Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final amendments to the fringe benefit regulations relating to the valuation of fringe benefits under section 61 and the exclusion of certain benefits as working condition fringes under section 132(a)(3) of the Internal Revenue Code of 1986. The final amendments: (1) Eliminate the requirement that employers must notify their employees of the election to use a special valuation rule, (2) clarify the requirements for using the special valuation rules, (3) provide additional rules for local transportation provided to government employees because of bona fide business-oriented security concerns, and (4) clarify the treatment of bona fide volunteers who perform services for exempt organizations or for a Federal, state, or local government unit. The final amendments affect any person providing or receiving these fringe benefits and provide these persons with the guidance necessary to comply with the law.

DATES: These rules are effective on December 30, 1992, except for the revision of § 1.61-21(c)(3)(ii) which is effective January 1, 1989, and the

removal of § 1.61-21(c)(3)(ii) which is effective January 1, 1985. However, taxpayers may treat the rules as applicable to benefits provided on or after January 1, 1989.

FOR FURTHER INFORMATION CONTACT:

Marianna Dyson, at 202-622-4606 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 25, 1991, the Treasury Department and the Internal Revenue Service published proposed amendments (56 FR 48465) to the final working condition fringe benefit regulations under section 132(d) of the Internal Revenue Code of 1986 (Code). The proposed amendments provide additional rules for transportation provided to government employees because of bona fide business-oriented security concerns and clarify the treatment of bona fide volunteers who perform services for exempt organizations or for a Federal, state, or local government unit. In addition, the notice of September 25, 1991, invited comments concerning the requirements under § 1.61-21(c) of the regulations, which sets forth the rules for notifying employees of the employer's election to use a special valuation rule for valuing a benefit in lieu of using the general valuation rules based on facts and circumstances.

Comments were received from the public, and on January 30, 1992, the Internal Revenue Service held a public hearing concerning the proposed amendments. In response to the comments and a statement made at the public hearing, this Treasury decision adopts the proposed amendments to the fringe benefit regulations as revised.

The amendments to the final regulations under section 61 are contained in § 1.61–21. The amendments to the final regulations under section 132 are contained in §§ 1.132–0, 1.132–1, and 1.132–5.

2. Volunteers

Background

Public comments were received by the Service expressing concern about the application of section 132 to volunteers who perform services for organizations exempt under section 501(a) of the Code and who receive directors' and officers' liability insurance protection (D&O insurance) from those organizations.

Section 132(a) of the Code excludes certain fringe benefits from gross income. Generally, these fringe benefits are excludable by an "employee," whether the employee is compensated or is working as a volunteer. For certain purposes, the term "employee," which is defined in § 1.132–1(b), includes independent contractors. For purposes of sections 132(a) (1) and (2) (relating to no-additional-cost services and qualified employee discounts), however, independent contractors are not treated as "employees." Thus, under section 132(a), bona fide volunteers, like their paid counterparts, may not exclude no-additional-cost services and qualified employee discounts from gross income unless the exempt organization or government employer has the right to direct and control the volunteer's services (*i.e.*, there is an employer-employee relationship).

Although volunteers who are employees may exclude from gross income the fringe benefits listed above, and all volunteers (including independent contractors) may exclude de minimis fringe benefits, the language of § 1.132–1(b) relating to working condition fringes does not encompass bona fide volunteers.

Section 132(d) of the Code and § 1.132–5(a)(1) of the income tax regulations provide that a "working condition fringe" is any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under section 162 or 167. (For purposes of the working condition fringe exclusion, the term "employee" is defined broadly to include employees, partners, directors and independent contractors).

Section 162 of the Code provides a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. An individual engaged in carrying on a trade or business has a profit-motive for purposes of section 162. An individual who performs services as a bona fide volunteer does not have a profit motive and thus cannot claim a deduction under section 162 for expenses incurred in connection with such volunteer work. For example, the value of D&O insurance provided to the volunteer would not be excludable as a working condition fringe benefit, even though the same insurance coverage would be excludable from the income of a paid employee or director who has a profit motive.

To correct this technical problem, the Service, pursuant to the authority granted in section 132(k), proposed an amendment to the regulations which was published in the *Federal Register* on September 25, 1991 (56 FR 48465). As stated in the preamble, the proposed amendment is intended to ensure that, like their paid counterparts, bona fide volunteers may exclude working condition fringe benefits, including D&O insurance, from gross income.

The proposed amendment provides that, solely for purposes of section 132(d), a bona fide volunteer, including a director or officer, who performs services for an organization that is exempt from tax under section 501(a), or for a Federal, state, or local government unit, is deemed to have a profit motive for purposes of section 162. Under the proposed amendment, an individual who provides services (including services as an officer, trustee, or director) is, for purposes of section 132(d), a "bona fide volunteer" for an exempt organization or government unit only if the total value of the benefits provided with respect to the volunteer services is substantially less than the total value of the volunteer services the individual provides to the organization. The value of liability insurance coverage is deemed, under the proposed regulation, to be substantially less than the value of the individual's volunteer services to the organization, provided the insurance coverage is limited to acts performed in the discharge of official duties or the performance of services on behalf of the exempt organization or government employer.

Explanation

All of the comments praised the proposed amendment concerning the treatment of bona fide volunteers and urged final adoption quickly. Some of the comments also suggested that the scope of the proposed amendment be expanded and/or clarified to ensure that various issues are addressed.

A few of the comments requested clarification that the receipt of nominal amounts of compensation for services does not disqualify bona fide volunteers from taking advantage of the section 132(a)(3) working condition fringe exclusion. This concern is addressed not only by the definition of a "bona fide volunteer" in the final amendments, but by the general definition of a working condition fringe in section 132(d).

The final regulations provide that a bona fide volunteer is someone who does not have a profit motive under section 162, but is deemed to have a profit motive only for purposes of the working condition fringe exclusion. The most typical example is the unpaid individual who performs services for an exempt organization or government employer and may receive benefits, but the total value of the benefits provided by the exempt organization or government employer is substantially less than the total value of the volunteer services that the individual provides to the organization. The receipt of D&O liability insurance by the bona fide volunteer, or an exempt organization or government employer's undertaking to indemnify the volunteer for liability, does not by itself confer a profit motive on the volunteer, provided the insurance coverage or indemnification relates to acts performed by the volunteer in the discharge of duties, or the performance of services, on behalf of the exempt organization or government employer. In the case of such a bona fide volunteer, new paragraph (r) of § 1.132-5 deems the volunteer to have a profit motive and thus insures that the volunteer may exclude the value of the D&O insurance provided by the exempt organization or government employer as a working condition fringe.

If it is determined that the individual does, in fact, have a profit motive within the meaning of section 162 and is not a "bona fide volunteer" within the meaning of § 1.132-5(r), the value of the D&O insurance provided by the organization is excludable from the individual's gross income as a working condition fringe by application of

section 132(a)(3). This is because, under section 132(d), a payment for D&O insurance by an individual with a profit motive would be allowable as a deduction under section 162 had he or she paid for it directly. To summarize, as a result of this Treasury Decision in conjunction with existing statutory provisions, the value of D&O insurance and of other working condition fringes provided to an individual who performs services for a tax-exempt organization or government employer is excludable as a working condition fringe whether or not the individual has a profit motive.

One comment suggested that indemnification payments permitted by law, whether made by an insurer or directly by the employer, should be treated in the same manner as D&O insurance premiums. The final regulations adopt this suggestion.

A few comments suggested that the final regulations address the application of the self-dealing rules of section 4941, as well as the application of Rev. Rul. 82-223, 1982-2 C.B. 301, to private foundations' D&O insurance premiums and indemnification payments. The resolution of this issue is not possible in the context of this final regulation, but will be addressed separately.

Like other tax-exempt organizations, private foundations need not allocate portions of D&O insurance premiums to individual directors and officers or include any such allocable amounts in Form 1099 or W-2, provided such amounts are excludable from gross income under the final regulations. Whether or not such allocable amounts need to be treated as compensation for the limited purpose of section 4941, no employer should issue a Form 1099 or W-2 for any such amount that is excludable from gross income as a working condition fringe benefit described in section 132(d).

Finally, in response to one comment, an example is included to illustrate the provisions of the final regulation.

The rules of § 1.132-5(r) are effective on December 30, 1992; however, taxpayers may treat the rules as applicable to benefits provided on or after January 1, 1989.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and

the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Marianna Dyson, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Service and Treasury Department participated in their development.

List of Subjects in 26 CFR 1.61-1 Through 1.133-1T

Income taxes, Reporting and recordkeeping requirements.

Adoption of the Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 1.61-2T [Amended]

Par. 2. Section 1.61-2T is amended as follows:

1. Paragraph (c)(3)(ii) is removed.
2. The heading for paragraph (c)(3)(i) is removed and paragraph (c)(3)(i) is redesignated as paragraph (c)(3).

§ 1.61-21 [Amended]

Par. 3. Section 1.61-21 is amended as follows:

1. Paragraph (a)(7) is amended by revising the entry for § 1.61-21(c)(3).
2. Paragraph (a)(7) is amended by adding an entry for § 1.61-21(k).
3. Paragraph (c)(1) is revised.
4. Paragraph (c)(2)(i) is amended by revising the paragraph heading and adding a new sentence at the end.
5. Paragraphs (c)(2)(ii) and (c)(2)(iii) are redesignated (c)(2)(iii) and (c)(2)(iv) respectively.
6. A new paragraph (c)(2)(ii) is added.

7. The headings for paragraphs (c)(3) and (c)(3)(i) are revised and a new sentence is added at the end of paragraph (c)(3)(i).

8. Paragraph (c)(3)(ii) is revised.

9. The first sentence of paragraph (c)(7) is revised.

10. In paragraph (c)(4), the reference to paragraph "(j)" in the first sentence is removed and "(k)" is added in its place.

11. The revisions and additions read as follows:

§ 1.61-21 Taxation of fringe benefits.

(a) * * *

(7) * * *

§ 1.61-21(c) Special valuation rules.

* * * * *

(3) Additional rules for using special valuation.

* * * * *

§ 1.61-21(k) Commuting valuation rule for certain employees.

- (1) In general.
- (2) Trip-by-trip basis.
- (3) Commuting value.
- (4) Definition of employer-provided transportation.
- (5) Unsafe conditions.
- (6) Qualified employee defined.
- (7) Examples.
- (8) Effective date.

* * * * *

Par. 4. Section 1.132-0 is amended as follows:

1. The entry for § 1.132-5(m)(6) is revised; and the entries for paragraphs (m)(7) and (m)(8) are added.

2. An entry for § 1.132-5(r) is added.

3. The revisions and additions read as follows:

§ 1.132-0 Outline of regulations under section 132.

* * * * *

§ 1.132-5(m) Employer-provided transportation for security concerns.

* * * * *

(6) Special valuation rule for government employees.

(7) Government employer and employee defined.

(8) Examples.

* * * * *

§ 1.132-5(r) Volunteers.

- (1) In general.
- (2) Limit on application of this paragraph.
- (3) Definitions.
- (4) Example.

* * * * *

Par. 5. Section 1.132-1(g) is amended by adding two sentences after the first sentence to read as follows:

§ 1.132-1 Exclusion from gross income for certain fringe benefits.

(g) * * * Furthermore, in § 1.132-5, the eleventh sentence of paragraph (m)(1), Examples 6 and 7 in paragraph (m)(8), and paragraphs (m)(2)(i), (m)(2)(v), (m)(3)(iv), (m)(6), (m)(7), and (r) are effective on December 30, 1992; however, taxpayers may treat the rules as applicable to benefits provided on or after January 1, 1989. For the applicable rules relating to employer-provided transportation for security concerns prior to December 30, 1992, see § 1.132-5(m) (as contained in 26 CFR part 1 (§§ 1.61 to 1.169) revised April 1, 1992).

Par. 6. Section 1.132-5 is amended as follows:

1. A new sentence is added between the tenth and eleventh sentences of paragraph (m)(1).
2. Paragraph (m)(2)(i) is revised.
3. Paragraphs (m)(2)(v) and (m)(3)(iv) are added.
4. Paragraph (m)(6) is redesignated as paragraph (m)(8) and Examples (6) and (7) are added.
5. Paragraphs (m)(6) and (m)(7) are added.
6. Paragraph (r) is added.
7. The revisions and additions read as follows:

§ 1.132-5 Working condition fringes.

(r) *Volunteers*—(1) *In general.* Solely for purposes of section 132(d) and paragraph (a)(1) of this section, a bona fide volunteer (including a director or officer) who performs services for an organization exempt from tax under section 501(a), or for a government employer (as defined in paragraph (m)(7) of this section), is deemed to have a profit motive under section 162.

(2) *Limit on application of this paragraph.* This paragraph (r) shall not be used to support treatment of the bona fide volunteer as having a profit motive for purposes of any provision of the Internal Revenue Code of 1986 (Code) other than section 132(d). Nothing in this paragraph (r) shall be interpreted as determining the employment status of a bona fide volunteer for purposes of any section of the Code other than section 132(d).

(3) *Definitions*—(i) *Bona fide volunteer.* For purposes of this paragraph (r), an individual is

considered a "bona fide volunteer" if the individual does not have a profit motive for purposes of section 162. For example, an individual is considered a "bona fide volunteer" if the total value of the benefits provided with respect to the volunteer services is substantially less than the total value of the volunteer services the individual provides to an exempt organization or government employer.

(ii) *Liability insurance coverage for a bona fide volunteer.* For purposes of this paragraph (r), the receipt of liability insurance coverage by a volunteer, or an exempt organization or government employer's undertaking to indemnify the volunteer for liability, does not by itself confer a profit motive on the volunteer, provided the insurance coverage or indemnification relates to acts performed by the volunteer in the discharge of duties, or the performance of services, on behalf of the exempt organization or government employer.

(4) *Example.* The following example illustrates the provisions of paragraph (r) of this section.

Example. A is a manager and full-time employee of P, a tax-exempt organization described in section 501(c)(3). B is a member of P's board of directors. Other than \$25 to defray expenses for attending board meetings, B receives no compensation for serving as a director and does not have a profit motive. Therefore, B is a bona fide volunteer by application of paragraph (r)(3)(i) of this section and is deemed to have a profit motive under paragraph (r)(1) of this section for purposes of section 132(d). In order to provide liability insurance coverage, P purchases a policy that covers actions arising from A's and B's activities performed as part of their duties to P. The value of the policy and payments made to or on behalf of A under the policy are excludable for A's gross income as a working condition fringe, because A has a profit motive under section 162 and would be able to deduct payments for liability insurance coverage had he paid for it himself. The receipt of liability insurance coverage by B does not confer a profit motive on B by application of paragraph (r)(3)(ii) of this section. Thus, the value of the policy and payments made to or on behalf of B under the policy are excludable from B's income as a working condition fringe. For the year in which the liability insurance coverage is provided to A and B, P may exclude the value of the benefit on the Form W-2 it issues to A or on any Form 1099 it might otherwise issue to B.

Shirley D. Peterson,
Commissioner of Internal Revenue.

Approved: October 6, 1992.
Fred T. Goldberg, Jr.,
Assistant Secretary of the Treasury.
[FR Doc. 92-30941 Filed 12-29-92; 8:45 am]
BILLING CODE 4830-01-M

December 20, 1995 Treasury Regulations

65566 Federal Register / Vol. 60, No. 244 / Wednesday, December 20, 1995 / Rules and Regulations

participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits, and must translate foreign currencies on a consistent basis.

(j) *Administrative requirements*—(1) *In general.* The administrative requirements of this paragraph consist of the documentation requirements of paragraph (j)(2) of this section and the reporting requirements of paragraph (j)(3) of this section.

(2) *Documentation.* A controlled participant must maintain sufficient documentation to establish that the requirements of paragraphs (b)(4) and (c)(1) of this section have been met, as well as the additional documentation specified in this paragraph (j)(2), and must provide any such documentation to the Internal Revenue Service within 30 days of a request (unless an extension is granted by the district director). Documents necessary to establish the following must also be maintained—

(i) The total amount of costs incurred pursuant to the arrangement;

(ii) The costs borne by each controlled participant;

(iii) A description of the method used to determine each controlled participant's share of the intangible development costs, including the projections used to estimate benefits, and an explanation of why that method was selected;

(iv) The accounting method used to determine the costs and benefits of the intangible development (including the method used to translate foreign currencies), and, to the extent that the method materially differs from U.S. generally accepted accounting principles, an explanation of such material differences; and

(v) Prior research, if any, undertaken in the intangible development area, any tangible or intangible property made available for use in the arrangement, by each controlled participant, and any information used to establish the value of pre-existing and covered intangibles.

(3) *Reporting requirements.* A controlled participant must attach to his U.S. income tax return a statement indicating that it is a participant in a qualified cost sharing arrangement, and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached to Schedule M of any Form 5471 or to any Form 5472 filed with respect to that participant.

(k) *Effective date.* This section is effective for taxable years beginning on or after January 1, 1996.

(l) *Transition rule.* A cost sharing arrangement will be considered a qualified cost sharing arrangement, within the meaning of this section, if, prior to January 1, 1996, the arrangement was a bona fide cost sharing arrangement under the provisions of § 1.482-7T (as contained in the 26 CFR part 1 edition revised as of April 1, 1995), but only if the arrangement is amended, if necessary, to conform with the provisions of this section by December 31, 1996.

§ 1.482-7T [Removed]

Par. 4. Section 1.482-7T is removed.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 5. The authority for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 6. Section 301.7701-3 is amended by adding paragraph (e) to read as follows:

§ 301.7701-3 Partnerships.

* * * * *

(c) *Qualified cost sharing arrangements.* A qualified cost sharing arrangement that is described in § 1.482-7 of this chapter and any arrangement that is treated by the Service as a qualified cost sharing arrangement under § 1.482-7 of this chapter is not classified as a partnership for purposes of the Internal Revenue Code. See § 1.482-7 of this chapter for the proper treatment of qualified cost sharing arrangements.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In § 602.101, paragraph (c) is amended by adding an entry to the table in numerical order to read as follows:

“1.482-71545-1364”.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: November 30, 1995.
Leslie Samuels,
Assistant Secretary of the Treasury.
[FR Doc. 95-30617 Filed 12-19-95; 8:45 am]

BILLING CODE 4830-01-U

26 CFR Part 53

[TD 8639]

RIN 1545-AT03

Excise Tax On Self-Dealing By Private Foundations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that clarify the definition of self-dealing for private foundations. These regulations modify the application of the self-dealing rules to the provision by a private foundation of directors' and officers' liability insurance to disqualified persons. In general, these regulations provide that indemnification by a private foundation or provision of insurance for purposes of covering the liabilities of the person in his/her capacity as a manager of the private foundation is not self-dealing. Additionally, the amounts expended by the private foundation for insurance or indemnification generally are not included in the compensation of the disqualified person for purposes of determining whether the disqualified person's compensation is reasonable.

DATES: These regulations are effective December 20, 1995.

FOR FURTHER INFORMATION CONTACT: Terri Harris or Paul Accettura of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS, at 202-622-6070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 3, 1995 proposed regulations amending § 53.4941(d)-2(f) [EE-56-94, 1995-6 I.R.B. 39] under section 4941 of the Internal Revenue Code of 1986 were published in the Federal Register (60 FR 82). The proposed regulations provided that generally it would not be self-dealing, nor treated as the payment of compensation, if a private foundation were to indemnify or provide insurance to a foundation manager in any civil judicial or civil administrative proceeding arising out of the manager's performance of services on behalf of the foundation. After IRS and Treasury consideration of the public comments received regarding the proposed regulations, the regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

Section 4941(a) imposes a tax on each act of self-dealing between a

disqualified person and a private foundation. Section 4941(d)(1)(E) defines self-dealing to include any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. Prior to this Treasury decision, § 53.4941(d)-2(f)(1) provided that provision of insurance for the payment of chapter 42 taxes by a private foundation for a foundation manager was self-dealing unless the premium amounts were included in the compensation of the foundation manager. The payment of chapter 42 taxes by the private foundation on behalf of the foundation manager was self-dealing whether or not the amounts were included in the manager's compensation.

Section 53.4941(d)-2(f)(3) provided that the indemnification of certain expenses by a private foundation for a foundation manager's defense in a judicial or administrative proceeding involving chapter 42 taxes was not self-dealing. Such expenses must have been reasonably incurred by the manager in connection with such proceeding. Also, the manager must have been successful in such defense, or such proceeding must have been terminated by settlement, and the manager must not have acted willfully and without reasonable cause with respect to the act or failure to act which led to the liability for tax under chapter 42.

This Treasury decision expands the scope of the regulations to cover indemnification and insurance payments made by a private foundation to or on behalf of a foundation manager in connection with any civil proceeding arising from the manager's performance of services for the private foundation. The regulations also clarify the distinction between the treatment of indemnification and insurance payments under chapter 42 and the treatment of these same items for income tax purposes.

The proposed regulations resulted in some confusion as to whether certain indemnification and insurance payments would be considered compensatory or non-compensatory. The final regulations have been revised to provide greater clarity. They divide indemnification payments and insurance coverage into non-compensatory and compensatory categories, described comprehensively in § 53.4941(d)-2(f)(3) and (4). The second and third sentences of § 53.4941(d)-2(f)(1) of the proposed regulations have been removed because their substance was incorporated into § 53.4941(d)-2(f)(4). Generally, the non-compensatory category includes

indemnification and insurance payments that cover expenses reasonably incurred in proceedings that do not result from a willful act or omission of the manager undertaken without reasonable cause. These payments are viewed as expenses for the foundation's administration and operation rather than compensation for the manager's services. The compensatory category includes indemnification or insurance payments that cover taxes (including taxes imposed by chapter 42), penalties or expenses of correction, expenses that were not reasonably incurred, or expenses for proceedings that result from a willful act or omission of the manager undertaken without reasonable cause. These payments are viewed as being exclusively for the benefit of the manager, not the foundation.

The regulations provide that non-compensatory indemnification and insurance payments are not affected by the prohibition against self-dealing. Conversely, compensatory indemnification and insurance payments are considered acts of self-dealing unless they are added to the benefiting manager's total compensation for purposes of determining whether that compensation is reasonable. If the total compensation is not reasonable, the foundation will have engaged in an act of self-dealing.

In some instances, a foundation may purchase an insurance policy that provides both non-compensatory and compensatory coverage. Some commentators have recommended that no allocation of insurance premiums be required when a single policy of this sort is purchased. These commentators argue that the allocation requirement places an undue burden on private foundations. After careful consideration, the IRS and the Treasury Department have decided to retain the allocation provision in the final regulations. The self-dealing rules were meant to discourage foundations from relieving managers of penalties, taxes and expenses of correction, as well as expenses ultimately resulting from the manager's willful violation of the law. A rule that did not require an allocation to determine whether the disqualified person's compensation is reasonable for purposes of chapter 42 could have the opposite effect. The insurance allocation rules are now set forth in § 53.4941(d)-2(f)(5).

Some commentators requested a clearer statement of what is meant by the statement that indemnification or insurance premiums are to be treated as compensation to the benefiting foundation manager. The IRS and the

Treasury Department agree that further clarification is desirable. Accordingly, § 53.4941(d)-2(f)(7) has been added. It provides that treatment as compensation for the limited purpose of determining whether compensation is reasonable under chapter 42 is separate and distinct from treatment as income to the benefiting manager under the income tax provisions. Whether any amount of indemnification or insurance is included in the manager's gross income for individual income tax purposes is determined in accordance with section 132, without regard to the treatment of such amounts under chapter 42.

Finally, a provision has been added to the regulations specifying that a foundation may disregard de minimis benefits when calculating the total amount of compensation paid to an officer, director or foundation manager for purposes of determining whether that compensation is reasonable. In this context, a de minimis benefit is one excluded from gross income under section 132(a)(4). This provision makes explicit a Service position that has previously been reflected in the instructions to the Form 990-PF.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of this Treasury decision is Terri Harris, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 53

Excise taxes, Foundations, Investments, Lobbying, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 53 is amended as follows:

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

Paragraph 1. The authority for part 53 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 2. Section 53.4941(d)-2 is amended as follows:

1. Paragraph (f)(1) is amended by removing the second and third sentences and revising the fourth sentence.

2. Paragraph (f)(3) is revised.

3. Paragraph (f)(4) is redesignated as paragraph (f)(9).

4. New paragraphs (f)(4) through (f)(8) are added.

The additions and revisions read as follows:

§ 53.4941(d)-2 Specific acts of self-dealing.

* * * * *

(f) Transfer or use of the income or assets of a private foundation—(1) In general. * * * For purposes of the preceding sentence, the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person.

* * * * *

(3) Non-compensatory indemnification of foundation managers against liability for defense in civil proceedings. (i) Except as provided in § 53.4941(d)-3(c), section 4941(d)(1) shall not apply to the indemnification by a private foundation of a foundation manager, with respect to the manager's defense in any civil judicial or civil administrative proceeding arising out of the manager's performance of services (or failure to perform services) on behalf of the foundation, against all expenses (other than taxes, including taxes imposed by chapter 42, penalties, or expenses of correction) including attorneys' fees, judgments and settlement expenditures if—

(A) Such expenses are reasonably incurred by the manager in connection with such proceeding; and

(B) The manager has not acted willfully and without reasonable cause with respect to the act or failure to act which led to such proceeding or to liability for tax under chapter 42.

(ii) Similarly, except as provided in § 53.4941(d)-3(c), section 4941(d)(1)

shall not apply to premiums for insurance to make or to reimburse a foundation for an indemnification payment allowed pursuant to this paragraph (f)(3). Neither shall an indemnification or payment of insurance allowed pursuant to this paragraph (f)(3) be treated as part of the compensation paid to such manager for purposes of determining whether the compensation is reasonable under chapter 42.

(4) Compensatory indemnification of foundation managers against liability for defense in civil proceedings. (i) The indemnification by a private foundation of a foundation manager for compensatory expenses shall be an act of self-dealing under this paragraph unless when such payment is added to other compensation paid to such manager the total compensation is reasonable under chapter 42. A compensatory expense for purposes of this paragraph (f) is—

(A) Any penalty, tax (including a tax imposed by chapter 42), or expense of correction that is owed by the foundation manager;

(B) Any expense not reasonably incurred by the manager in connection with a civil judicial or civil administrative proceeding arising out of the manager's performance of services on behalf of the foundation; or

(C) Any expense resulting from an act or failure to act with respect to which the manager has acted willfully and without reasonable cause.

(ii) Similarly, the payment by a private foundation of the premiums for an insurance policy providing liability insurance to a foundation manager for expenses described in this paragraph (f)(4) shall be an act of self-dealing under this paragraph (f) unless when such premiums are added to other compensation paid to such manager the total compensation is reasonable under chapter 42.

(5) Insurance Allocation. A private foundation shall not be engaged in an act of self-dealing if the foundation purchases a single insurance policy to provide its managers both the noncompensatory and the compensatory coverage discussed in this paragraph (f), provided that the total insurance premium is allocated and that each manager's portion of the premium attributable to the compensatory coverage is included in that manager's compensation for purposes of determining reasonable compensation under chapter 42.

(6) Indemnification. For purposes of this paragraph (f), the term indemnification shall include not only reimbursement by the foundation for

expenses that the foundation manager has already incurred or anticipates incurring but also direct payment by the foundation of such expenses as the expenses arise.

(7) Taxable Income. The determination of whether any amount of indemnification or insurance premium discussed in this paragraph (f) is included in the manager's gross income for individual income tax purposes is made on the basis of the provisions of chapter 1 and without regard to the treatment of such amount for purposes of determining whether the manager's compensation is reasonable under chapter 42.

(8) De minimis items. Any property or service that is excluded from income under section 132(a)(4) may be disregarded for purposes of determining whether the recipient's compensation is reasonable under chapter 42.

* * * * *

Margaret Milner Richardson, Commissioner of Internal Revenue.

Approved: December 12, 1995.

Leslie Samuels,

Assistant Secretary of Treasury.

[FR Doc. 95-30838 Filed 12-19-95; 8:45 am]

BILLING CODE 4830-01-U

Fiscal Service

31 CFR Part 390

Collection By Administrative Offset

AGENCY: Bureau of the Public Debt, Fiscal Service, Department of the Treasury.

ACTION: Final rule.

SUMMARY: This final rule amends Title 31 by removing Part 390. The action is being taken because the Treasury Department's promulgation of administrative offset regulations at 31 CFR Part 5, Subpart D, made Part 390 unnecessary.

EFFECTIVE DATE: December 20, 1995.

FOR FURTHER INFORMATION CONTACT: Ed Gronseth, Deputy Chief Counsel, Bureau of the Public Debt, Parkersburg, WV (304) 480-5187.

SUPPLEMENTARY INFORMATION:

Background

Part 390 applied to the collection of claims by administrative offset by the Bureau of the Public Debt. The rule was needed to implement the administrative offset provisions of section 10 of the Debt Collection Act of 1982, (31 U.S.C. 3716). Subsequent to the adoption of this rule, the Department of the Treasury promulgated Department-wide

Charitable Foundation Boards, Risk Management and Liability Insurance

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The boards of charitable foundations have wide-ranging responsibilities. In a small community foundation, the members of the board may both establish *and* carry out policy. In larger foundations, the board often hires staff to implement its policy directives. However, even with employees, the board continues to have critical responsibilities. Just as the operations of charitable foundations have grown increasingly complex, the risks facing foundations are multidimensional. When a risk becomes reality, the organization's mission and grantmaking may be in jeopardy, especially if the foundation is caught off guard. With strong leadership and unwavering community support, the foundation may weather a difficult storm with minimal damage. Or, the foundation may sustain severe blows to its reputation and resources and decide to close its doors.

Risk management is a discipline for dealing with uncertainty. By identifying risks and taking steps to manage uncertainty, a charitable foundation increases its chances of survival in the face of unfortunate and even catastrophic incidents. Significant investment losses, embezzlement, or irreparable damage to a facility are all incidents that could destroy any unprepared foundation.

But risk management doesn't begin or end with the purchase of property or liability insurance. Nor is it simply about working with a licensed insurance professional. Although insurance may be an integral part of a foundation's operation, insurance only provides a way to pay for losses. Risk management extends beyond determining how to pay for losses; it involves identifying risks, minimizing the likelihood of harm and establishing the organization's response to unfortunate events.

At the board level, risk management starts with accountability. It provides a means for the board to meet its legal responsibilities and fulfill numerous governance roles. The board is accountable to the numerous constituencies served by the foundation and responsible for the overall well-being of the organization. The board's ultimate responsibility is to ensure that the foundation achieves its mission.

Know Your Legal Duties

State laws governing the establishment and operation of charitable foundations support the basic premise that the board of directors is responsible for the affairs of the corporation. Board members owe the charitable foundations on which they serve the common law duties of loyalty, care and obedience. A duty is the

responsibility owed by a board member in reference to the capacity in which a director or officer renders services to the organization. The liability of foundation boards for actions taken on behalf of the organization depends upon whether or not a duty to act in a certain manner existed. If no statutory standard exists, the courts examine the common law standards. These standards are based on the following duties:

1. The *duty of loyalty* requires that officers and directors act in good faith, avoid activities that will harm the organization and not allow their personal interests to prevail over the interests of the organization.

The duty of loyalty requires that board members avoid both self-dealing in transactions with the foundation or using their positions of trust for personal advantage. In addition, a foundation board member should demonstrate unselfish loyalty to the organization and avoid any conflict—or appearance thereof—between the organization’s interests and those of the board member.

2. The *duty of care* requires that board members use diligence in governing the organization. The courts often interpret this duty as applying the care that an ordinarily prudent person would use under similar circumstances.

Under the “business judgment rule,” directors and officers are immune from personal liability for mistakes attributed to business judgment provided there was no illegal conduct and that the director(s) acted responsibly. To fulfill the duty of care, board members must be proactive by regularly attending and participating in meetings, while staying abreast of the organization’s affairs. Additionally, the board should implement programs and safeguards that promote appropriate conduct, and detect and address inappropriate conduct.

3. The *duty of obedience* requires that a board member act only within the scope of the powers granted by law or the nonprofit’s charter, articles of incorporation and bylaws. *Ultra vires* actions are those that fall outside the scope of a board member’s authority. An individual board member, or the entire board if appropriate, can be held personally responsible for *ultra vires* acts. The common law duty of obedience also requires that the board adopt and follow conduct protocols, or rules and procedures that govern its actions. Examples of board protocols include rules concerning the number of meetings held each year, board meeting minutes and filing of reports required by regulators. Failure to establish and follow board protocol may defeat the protection afforded by the “corporate veil” of incorporation and lead to personal liability for the results.

Pursue a Multifaceted Strategy

As growth of the charitable sector continues, the need for committed, enthusiastic and capable foundation board members has never been greater. While claims against foundation boards remain rare, the fear of liability continues to grow. This fear is fueled, in part, by widespread publicity surrounding celebrated cases, which leads to more claims. Every foundation must work diligently to recruit and retain suitable board leaders. One strategy to address the potential for personal liability is to take steps to substantially reduce the likelihood that a board member's personal assets will be exposed to loss. We describe a three-part protection strategy for nonprofit boards to consider.

1. **Risk Control.** Every charitable foundation should strive to reduce the potential of a claim against the board or organization. One technique is to form a risk management committee to coordinate the process of risk identification and strategy development. Even the smallest foundation can establish a risk management committee. Begin with examining the board's governance activities and the common law duties owed by every board member. The process of identifying risks and implementing appropriate strategies should extend into all major operational areas. The foundation should focus first on high priority risks—those most likely to occur and those with the greatest potential for financial and adverse affect on the organization. The most effective risk management strategy is the one that avoids a loss. Financing potential claims by the purchase of D&O liability insurance coverage or other means should be approached only after you have first tried to minimize the likelihood of claims. Remember, however, that no strategy can eliminate the possibility of a loss.

2. **Indemnification and Volunteer Protection.** Most foundation bylaws include indemnification provisions—language that expresses the intent of the organization 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 times, however, when indemnification is unavailable or becomes a hollow promise:

- The foundation does not have sufficient resources to pay the losses and expenses incurred by a director or officer.
- State or federal law prohibits indemnification due to public policy considerations.
- The board refuses to authorize the indemnification.

Every state has a volunteer protection law and the 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 harm caused by an act or omission of the volunteer on behalf of the organization. The VPA also provides some limitations on the assessment of

noneconomic losses and punitive damages against a volunteer. However, the VPA does not 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 VPA does not prohibit lawsuits against volunteers, just the potential recovery.

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. For a summary of the federal law, detail on each state’s law, and commentary on recent cases citing a state volunteer protection law or the VPA, see the free publication titled *State Liability Laws for Charitable Organizations and Volunteers* featured at www.nonprofitrisk.org.

3. **Risk Financing.** Every foundation 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.

Finance Risks Responsibly

Today, about a dozen U.S.-based insurers sell the vast majority of D&O coverage tailored for nonprofit organizations. However, there is no “standard” D&O policy so the policy language and coverage differs from one form to the next. This diversity makes it difficult for board members to evaluate a foundation’s D&O policy.

A D&O insurance policy provides coverage for the costs (defense and settlement) of claims arising from any actual or alleged “wrongful acts” taken by directors, officers and other “insureds” under the policy. The person making these allegations may be an insider such as an employee or volunteer, or an outsider such as a grant recipient, donor or government official.

Every charitable foundation must decide whether it should purchase D&O insurance. The foundation’s indemnification agreement for the board members is only as good as the financial resources available to fund the indemnification. Some wrongful acts are neither insurable nor indemnifiable, however the vast majority of allegations against the board, staff and the organization will be activities potentially covered by a D&O policy. The following sections provide explanations and guidance in reviewing the contract’s language.

1. **Claims-Made Policy.** D&O liability insurance policies are generally, but not always written on a claims-made basis. Under a claims-made policy, coverage is triggered based on when the claim is made, not when the incident giving rise to the claim occurred. For example, a nonprofit has a D&O policy running from January 1, 2008 to January 1, 2009. The nonprofit terminates an employee in December 2007. The terminated employee sues the nonprofit in December 2008, alleging age discrimination and wrongful termination. A traditional claims-made form should respond because the claim (lawsuit) was made during the policy period, despite the fact that the alleged wrongful act (the termination) occurred before the policy period.

Increasingly, most D&O policies require that the claim must be made *and* reported to the insurance company during the policy period. Therefore, it is important to understand first how the policy defines a claim and secondly, what your requirements are for reporting the claim to the insurance company. Timely reporting is critical since the insurance company may deny the claim if it is not reported properly.

2. **Entity Coverage.** Historically, D&O policies only covered the directors and officers of a corporation, not the corporation itself. Today, most companies have modified their nonprofit D&O forms to also cover the organization or “entity.” Under a policy with *entity* coverage, the nonprofit may be called the “insured entity,” “organization,” “association,” or even simply the “entity.” Entity coverage is probably crucial for your foundation. First, your foundation is a likely target in litigation brought by a disgruntled employee, grant recipient or outsider. It is also possible that only the foundation—and not individual directors—will be named. If this were to happen in a policy limiting coverage to directors and officers, no coverage would be provided for the lawsuit. Without the entity coverage, the insurance company may still defend the organization if named along with the directors and officers. However, the insurer might then allocate the costs between the insured directors and officers, and the uninsured nonprofit, and seek reimbursement from the nonprofit for its defense costs.

3. **Definition of Insured.** Some D&O policies, especially “for-profit” forms, contain a narrow definition of “insured”—limiting coverage to *current* directors and officers of the organization. A more extensive policy will contain a broad definition of insured. The definition may provide coverage for the entity and all past, present and future directors, officers, trustees, employees, committee members, volunteers, and spouses of current, past or future trustees. A savvy plaintiff’s attorney will likely name everyone connected to the event or decision in a suit alleging injury. A broad definition of insured offers protection to named defendants that falls outside the narrow definition of “director” or “officer.”

4. **Definition of “Wrongful Act.”** Another important definition in determining policy coverage is “wrongful act.” The definitions vary and are significant because the “wrongful act” is the primary component of the policy’s insuring agreement.

In certain policies the definition of “wrongful act” is open-ended. Insurance advisors may argue that this form of construction works to the insured’s benefit if a potential claim does not fit within a prescriptive definition of a claim.

It is common to see a provision excluding coverage for wrongful acts committed in the service of an entity other than the organization purchasing the coverage. This makes sense. You may not want to provide coverage for all of your board and staff members’ volunteer activities. This harkens back to a fundamental tenet of risk management: Do not assume liability for something or someone over which you do not have control. There are policies, however, that provide or can be endorsed to provide coverage for outside directorship liability with certain limitations.

5. Coverage for Employment Practices. Employment-related claims account for the vast majority of legal actions brought against nonprofits, including charitable foundations. And while there are many specific steps a foundation can and should take to reduce the likelihood of a claim, legal challenges cannot be avoided altogether without foregoing a workforce. Unless your organization has selected an alternative risk financing mechanism, liability insurance for employment-related actions is a wise investment. Today, most commercial general liability (CGL) policies contain an employment practices exclusion endorsement so coverage needs to be purchased elsewhere. A charitable foundation has three ways to obtain such coverage. First, some companies offer a very restrictive endorsement to the CGL policy. Second, your foundation can purchase a separate employment practices liability (EPL) policy. Third, many companies offer the coverage under a D&O policy, either by endorsement or as a part of the policy. Coverage under the D&O policy is the most common.

Most D&O policies provide employment practices coverage by defining an *employment practices wrongful act*. The definition indicates which employment actions are covered by the policy. Some D&O policies have a separate insuring agreement for employment practices liability. Finally, a very few D&O forms do not exclude employment-related claims specifically. The policy is “silent” on the matter and *may* be interpreted to provide coverage. However, the policy may contain a breach of contract exclusion that will negate employment-related coverage anyway. To rely on a policy that is silent on the topic of employment coverage, however, may be risky. The company may attempt to deny coverage or significantly limit coverage.

6. Defense Coverage. A motivating factor for purchasing nonprofit D&O coverage is to have funds available to pay for a defense against allegations of improper conduct. Many charitable foundations cannot afford to fund the substantial costs of a legal defense or prefer not to spend their financial assets on litigation.

Historically, under the corporate D&O policy it was the insured's duty to defend claims. An older Aetna policy states "(1) It shall be the duty of the *Insureds* and not the duty of Aetna to defend *Claims*. No *Defense Expenses* shall be incurred and no settlement of any *Claim* shall be made without Aetna's consent, such consent not to be unreasonably withheld." (F-1918 ED. 10-88). If the insurer does not have the duty to defend, the company may only reimburse the insured after the foundation has paid its defense expenses. In some cases the insurer will not pay these expenses until the claim is resolved. However, some of these policies do provide for the advancement of defense costs or will pay expenses on a current basis (as the insured incurs them).

Many nonprofit D&O policies provide the insurer's right and duty to defend claims and suits. However, the costs to investigate and defend the claim may be included in the limit of liability while some policies will provide defense costs in addition to the policy limit. Each foundation needs to evaluate its preferred limit of liability but must factor whether defense costs are inside or in addition to the limit of liability to determine the appropriate policy limit.

About the Authors

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This article was adapted from two publications—*The Best Defense: A Liability, Litigation and Legal Guide for Nonprofits* and *Coverage, Claims and Consequences: An Insurance Handbook for Nonprofits*. Both are available from the Nonprofit Risk Management Center by calling (202) 785-3891 or visiting the Center's website: www.nonprofitrisk.org. The website provides a wide variety of free resources on risk management as well as access to the Center's free technical assistance program for grantmaking and grant-seeking nonprofits.



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