

GIBSON, DUNN & CRUTCHER LLP



**REVISITING DIRECTOR AND OFFICER INDEMNIFICATION:
PROVISIONS IN THE NEW DC NONPROFIT ACT**

1. Initial Considerations

The District of Columbia has recently modernized its statute dealing with the indemnification of nonprofit directors and officers. The new law will apply to most nonprofits, effective January 1, 2012. As a result, this is an ideal time for your organization to take a fresh look at indemnification, including the new law's provisions, and to assess more generally the liability protections provided to your directors and officers.

2. Potential Liability and the Role of Indemnification

Although nonprofits are less likely than for-profit companies to become involved in litigation, nonprofits still face the risk of being sued or becoming the target of an investigation.

Most suits against nonprofits involve employment matters, such as claims for wrongful termination, discrimination or sexual harassment. However, nonprofits may also become involved in litigation relating to financial mismanagement, and it is possible that a nonprofit's directors and

officers may face liability in connection with these matters.

One way to protect directors and officers from liability is through indemnification. Indemnification is an agreement by one person or entity to pay the obligations of another. In this way, when a nonprofit indemnifies its directors and officers, it is agreeing to pay their legal fees, expenses, judgments and settlement costs, if the officer or director is sued as a result of his or her service with the nonprofit.

Indemnification can play a key role in attracting qualified individuals to serve as directors and officers, as it provides assurances that they will not be personally liable for costs incurred in the carrying out of their official duties.

There are important limits, however, on the extent that indemnification can protect directors and officers. For example, a nonprofit may not have sufficient funds available to make good on its promise to indemnify. This is a particular concern for smaller nonprofits that may not be in the financial position to handle the high costs of litigation, investigations or settlements.

In addition, as will be discussed more below, the law limits the extent to which nonprofits can indemnify their directors and officers. The nonprofit may purchase director and officer insurance (“D&O insurance”) in order to address many of these limitations. D & O insurance helps alleviate concerns about a nonprofit’s financial condition and can provide protection in cases where indemnification is not legally permitted.

3. Summary of New Act Provisions

The District of Columbia Nonprofit Corporation Act of 2010 (the “Act”) makes significant changes to current law. The current Nonprofit Code provides little guidance to nonprofits about their ability to indemnify officers and directors. However, the new Act contains indemnification provisions that are similar to those of most states. A summary of the Act’s key features is provided below.

The Act now provides for three types of indemnification:

- Mandatory Indemnification
- Permissive Indemnification
- Court-ordered Indemnification

Mandatory Indemnification: Under the Act, a nonprofit is required to indemnify directors and officers to the extent they are successful in the defense of any lawsuit arising from their positions with the nonprofit. This mandatory indemnification includes the payment of reasonable expenses and attorneys’ fees incurred in connection with the lawsuit. Directors and officers are entitled to enforce their right to mandatory indemnification in court.

Permissive Indemnification: In addition, the Act permits, but does not require, a

nonprofit to indemnify officers and directors in certain other circumstances.

In particular, a nonprofit may indemnify a director or officer for amounts paid as a judgment, settlement or fine, if the director or officer meets the required standard of conduct.

To satisfy the required standard of conduct, the director or officer generally must:

- have acted in good faith, and
- reasonably believed that his or her conduct was in the best interests of the nonprofit, or not opposed to them.

In the case of a criminal matter, the director or officer must also have had no reasonable cause to believe that his or her conduct was unlawful.

In each instance, the Board of Directors must authorize the indemnification once it determines that the director or officer has met the required standard of conduct.

This determination should be made by a majority vote of all disinterested directors (that is, directors who were not involved in the legal proceeding).¹ If there are less than two disinterested directors, then the determination must be made by legal counsel who is chosen for this purpose by the directors.

Generally, a nonprofit entity’s articles of incorporation or bylaws will include provisions specifying that that the nonprofit will indemnify its directors and officers.

¹ In the case of a nonprofit that has voting members (i.e., members who vote to elect directors and approve major corporate transactions) the members may vote on whether to indemnify an officer or director.

This type of provision will obligate the nonprofit to indemnify its directors and officers in cases where they have satisfied the required standard of conduct described above.

Advancement of Expenses: Litigation can be expensive. The legal costs can mount quickly and may be due long before a proceeding has concluded. An officer or director may not be able to afford the cost of defending themselves in a legal proceeding. Therefore, the Act permits a nonprofit to advance funds to a director or officer to pay for legal and other expenses before a legal proceeding has concluded.

In order to be eligible for advancement of expenses, the director or officer must submit to the nonprofit:

- (1) an affirmation generally stating that he or she has met the required standard of conduct, and
- (2) an undertaking to repay any amounts advanced if it turns out that he or she ultimately is not entitled to indemnification.

As with permissive indemnification, nonprofits generally will include a provision in their articles of incorporation or bylaws obligating the nonprofit to provide for advancement of expenses, and not just indemnification, consistent with the statute.²

² The Act states that a nonprofit may provide in its articles of incorporation or bylaws that it will indemnify the officer or director “to the fullest extent permitted by law.” In such case, the nonprofit will be legally obligated to indemnify every officer or director to the fullest extent permitted by the Act, regardless of the nonprofit’s financial or other circumstances at the time of the indemnification. In addition the nonprofit will be obligated to advance expenses to the fullest extent permissible, unless the

Limitations on Indemnification: The Act places a number of specific limitations on a nonprofit’s ability to indemnify its directors and officers. In particular, a nonprofit:

- can only indemnify for reasonable expenses, and not for amounts of any judgment, settlement or fine, in the event that a director or officer is being sued by or on behalf of the nonprofit itself;
- cannot indemnify a director or officer found liable for receiving an improper financial benefit; and
- cannot indemnify an officer for liability arising out of intentional infliction of harm on the nonprofit or intentional violation of a criminal law.

Court-Ordered Indemnification and Advancement: The Act provides that directors and officers may apply to the District of Columbia Superior Court for indemnification or advancement of expenses in certain circumstances. For example, a director or officer may appeal to the court to enforce his or her rights to mandatory indemnification or rights to indemnification or advancement that are set forth in the nonprofit’s articles of incorporation or bylaws. In addition, a court may also require indemnification or advancement if it determines that, in view of the circumstances, it would be “fair and reasonable.”

Other Matters: The Act includes a number of additional provisions that may be of interest to your organization:

articles of incorporation or bylaws explicitly state otherwise.

- The Act explicitly permits nonprofits to purchase insurance on behalf of its directors and officers for liability they may incur as a result of their official duties. The Act acknowledges that protection from insurance can be broader than that afforded by indemnification, as insurance can shield directors and officers from liability “whether or not the [nonprofit] would have the power to indemnify or advance expenses to the individual against the same liability” under the Act.³
- The Act also allows nonprofits to elect to indemnify their directors and officers for expenses incurred as a witness in cases where they are not themselves parties to the litigation.

Finally, the Act allows nonprofits to indemnify, advance expenses to and provide insurance for, employees, agents and volunteers to the same extent that it does for directors and officers. Nonprofits with limited financial resources should give careful consideration to which, if any, of

³ The Act also provides that a nonprofit volunteer cannot be held liable for any acts or omissions except:

- The volunteer’s willful misconduct;
- The volunteer’s criminal conduct, unless the volunteer had reasonable cause to believe that the conduct was not illegal;
- A transaction that resulted in an improper benefit to the volunteer; and
- Any action taken that was not in good faith and beyond the authority of the nonprofit.

In order to invoke the protections of the statute, the nonprofit must either maintain liability insurance at least equal to \$200,000 per individual claim and \$500,000 for total claims or, in the case of an exempt, 501(c)(3) organization, have annual functional expenses, exclusive of grants and allocations, of less than \$100,000 per year.

these individuals they would like to extend indemnification to, so that they do not create obligations that they may have difficulty satisfying.

4. Directors and Officers Insurance

In order for a nonprofit to protect its officers and directors, and to fund its obligation to indemnify officers and directors from liability, a nonprofit should obtain directors’ and officers’ liability insurance.

A D&O policy more broadly covers liability arising from an alleged “wrongful act” committed by the officer or director. It insulates your directors and officers from personal liability relating to participation on the board or running the nonprofit.

The wrongful acts covered by a D&O policy include claims that the officer or director breached his or her fiduciary duty when carrying out his or her responsibilities. It also covers claims that the officer or director discriminated against someone applying for benefits from the nonprofit.

For example, if an individual applies for housing from the nonprofit and is denied, the individual may claim that the nonprofit engaged in illegal discrimination when denying the benefits. The D&O policy is designed to cover such claims. In addition, nonprofit D&O policies may also cover employment discrimination claims. A nonprofit should check with its insurance broker to see if its D&O policy covers such claims.

A nonprofit D&O policy should insure not only the directors and officers, but also the employees, volunteers and the nonprofit organization itself. It should also include a “duty to defend” clause, which provides that the insurance company must hire an attorney

to defend any the officer and director in the course of the litigation. The benefit of this provision is that neither the officer or director nor the nonprofit must pay the litigation costs in advance, and then wait for reimbursement from the insurance company.

5. What Should My Nonprofit Do?

With the enactment of the Act, now is a good time revisit the issue of indemnification and liability protection for the directors and officers serving your organization.

After familiarizing yourself with the terms of the Act, a useful next step is to assess whether revisions to your articles of incorporation and bylaws are appropriate. Often nonprofits will include a relatively brief provision in their articles of incorporation stating that they will indemnify their directors and officers to the fullest extent permitted by law, and then they will include in their bylaws more detailed information regarding indemnification and any rights to the advancement of expenses. As discussed above, many of the indemnification provisions in the Act are permissive rather than mandatory, and as a result nonprofits that wish to provide their directors and officers with the full scope of permitted protections should make sure that such protections are reflected in their governing documents. An example of an indemnification bylaw for a DC nonprofit is attached as an exhibit to this alert.

You may also wish to evaluate whether D&O insurance would be appropriate for your nonprofit, if you have not already obtained it. Even for nonprofits with little history of litigation, D&O insurance can provide a meaningful safeguard, as even frivolous claims need to be defended and

even relatively minor lawsuits can result in significant costs. Not only does D&O insurance shift the risk of litigation losses from the nonprofit to the insurer, it can also provide protection that goes beyond what can be indemnified pursuant to the terms of the Act.

6. Additional Resources

You may find the following information helpful:

Leonard M. Polisar & Anthony V. Raftopol, *When Charities Get Into Trouble: Limiting the Liability of Directors and Officers of Nonprofit Organizations*, in NONPROFIT GOVERNANCE AND MANAGEMENT (Victor Futter ed., 2002).

LISA A. RUNQUIST, THE ABCS OF NONPROFITS (2005).

John A. Edie & Jane C. Nober, *Directors and Officers: Liability Insurance and Indemnification* (2007), available at <http://www.cof.org/files/Documents/Legal/DandO.pdf>.

This communication is provided by the D.C. Bar Pro Bono Program and Gibson Dunn & Crutcher LLP as a public service solely for informational purposes, without any representation that it is accurate or complete. It does not constitute legal advice and should not be construed as such. It does not create an attorney-client relationship between the recipient and any other person, or an offer to create such a relationship. This communication contains information that is based, in whole or in part, on the laws of the District of Columbia and is current as of the date it is written. However laws vary from state to state and may change from time to time. As a result, the information may not be appropriate for anyone operating outside the District of Columbia and may no longer be timely. Consult an attorney if you have questions regarding the contents of this communication.

Exhibit

Sample Indemnification Provision for Nonprofit Bylaws

The following sample bylaw provision is provided for educational and informational purposes only. It is based on model language provided in an American Bar Association publication, *Nonprofit Governance and Management* (Victor Futter ed., 2002).

When adding indemnification provisions to your organization's bylaws, it is important that your organization determine how it will satisfy the financial obligations created by the indemnification provisions. Otherwise, your organization may not have sufficient unrestricted funds to make good on its promise to indemnify a director or officer who is sued. This is a particular concern for smaller nonprofit organizations that may not be in the financial position to handle the high costs of litigation, investigations or settlements. Your organization may want to purchase directors and officers insurance ("D&O insurance") in order to help ensure that there are sufficient funds to pay the indemnification obligation. In addition, you may want to obtain a form of D&O insurance policy that will pay up-front the attorneys' fees for defending such litigation. Therefore, it is important for you to consult with an attorney before adopting any amendment to your bylaws changing the indemnification provisions.

ARTICLE []

Indemnification

Except to the extent expressly prohibited by the District of Columbia Nonprofit Corporation Act of 2010 (the "Act"), the Corporation shall, without the requirement of any additional authorization by the Corporation, indemnify any person:

- (a) made or threatened to be made a party to,
- (b) called as a witness in, or
- (c) asked to provide information in connection with,

any pending or threatened action, proceeding, hearing, or investigation, or any appeal therein (other than an action or proceeding by or in the right of the Corporation to procure a judgment in its favor), whether civil or criminal, including an action by or in the right of any other corporation of any type or kind, domestic or foreign, or any partnership, joint venture, trust, employee benefit plan, or other enterprise, which any Director or Officer of the Corporation served in any capacity at the request of the Corporation, by reason of the fact that he or she is or was, or he or she is the executor, administrator, heir, or successor of a person who is or was a Director or Officer of the Corporation, or served such other corporation, partnership, joint venture, trust, employee benefit plan, or other enterprise in any capacity, against judgments, amounts paid in settlement, penalties, fines, including excise taxes assessed with respect to an

employee benefit plan, and reasonable expenses, including attorneys' fees actually and necessarily incurred as a result of such action or proceeding, or any appeal therein, if such Director or Officer:

- (d) acted in good faith,
 - (i) for a purpose that he or she reasonably believed to be in, or,
 - (ii) in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan, or other enterprise, not opposed to, the best interests of the Corporation and,
- (e) in criminal actions or proceedings, in addition, had no reasonable cause to believe that his or her conduct was unlawful.

Except to the extent expressly prohibited by the Act, the Corporation shall, without the requirement of any additional authorization by the Corporation, indemnify any person made, or threatened to be made, a party to an action by or in the right of the Corporation to procure a judgment in its favor by reason of the fact that he or she is or was, or he or she is the executor, administrator, heir, or successor of a person who is or was a Director or Officer of the Corporation, or is or was serving at the request of the Corporation as a Director or Officer of any corporation of any type or kind, domestic or foreign, of any partnership, joint venture, trust, employee benefit plan, or other enterprise, against reasonable expenses, including attorneys' fees, actually and necessarily incurred by him or her in connection with the defense or settlement of such action, or in connection with an appeal therein, if such Director or Officer:

- (a) acted, in good faith, for a purpose which he or she reasonably believed to be in, or,
- (b) in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan, or other enterprise, not opposed to, the best interests of the Corporation,

except that no indemnification under this paragraph shall be made in respect to:

- (1) a threatened action, or a pending action that is settled or otherwise disposed of, or
- (2) any claim, issue, or matter as to which such person shall have been judged to be liable to the Corporation, unless and only to the extent that the court in which the action was brought, or if no action was brought, any court of competent jurisdiction, determines upon application that, in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnity for such portion of the settlement amount and expenses as the court deems proper.

The termination of any civil or criminal action or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not in itself be determinative that such Director or Officer did not act in good faith for a purpose that he or she reasonably believed to be in, or, in the case of service for any other corporation or partnership, joint venture, trust, employee benefit plan or other enterprise, not opposed to the best interests of

the Corporation or that he or she had reasonable cause to believe that his or her conduct was unlawful.

No indemnification shall be made under this Bylaw if a judgment or other final adjudication adverse to such person establishes that his or acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled, and provided further that no such indemnification shall be required with respect to any settlement or other nonadjudicated position of any threatened or pending action or proceeding unless the Corporation has given its consent to such settlement or other disposition. The Corporation shall have the right to select attorneys and to approve any legal expenses incurred in connection with any suit, action or proceeding to which this indemnification applies. The Corporation shall advance or promptly reimburse all expenses, including attorneys' fees actually and reasonably incurred in defending any action or proceeding in advance of the final disposition thereof, upon receipt of a written affirmation by such person stating that such person has met the required standard of conduct set forth in the first or second paragraph of this Article, as applicable, or is otherwise entitled to indemnification, and a written undertaking, in the form of a unlimited general obligation, by such person to repay such amount if such person is ultimately found not to be entitled to indemnification, or, where indemnification is granted, to the extent the expenses so advanced or reimbursed exceed the amount to which such person is entitled.

Nothing in the Bylaw shall limit or affect any other right of any person to indemnification or expenses, including attorneys' fees, under any statute, rule, regulation, Certificate of Incorporation, Bylaw, insurance policy, contract, or otherwise.

No elimination of this Bylaw, and no amendment of this Bylaw adversely affecting the right of any person to indemnification or advancement of expenses hereunder shall be effective until the sixtieth day following notice to such person of such action, and no elimination of or amendment to this Bylaw shall deprive any person of his rights hereunder arising out of alleged or actual occurrences, acts, or failures to act prior to such sixtieth day. The provisions of this paragraph shall supersede anything to the contrary in these Bylaws.

The Corporation shall not, except by elimination or amendment of this Bylaw in a manner consistent with the preceding paragraph, take any corporate action or enter into any agreement which prohibits, or otherwise limits the rights of any person to indemnification in accordance with the provisions of this Bylaw. The indemnification of any person provided by this Bylaw shall continue after such person has ceased to be a Director or Officer of the Corporation and shall inure to the benefit of such person's heirs, executors, administrators, and legal representatives.

The Corporation is authorized to enter into agreements with any of its Directors, Officers, or employees extending rights to indemnification and advancement of expenses to such person to the fullest extent permitted by applicable law, or to provide such indemnification and advancement of expenses pursuant to *[a resolution of members or]* a resolution of the Board of Directors, but the failure to enter into any such agreement or to adopt any such resolutions shall

not affect or limit the rights of such person pursuant to this Bylaw. It is hereby expressly recognized that all Directors and Officers of the Corporation, by serving as such after the adoption hereof, are acting in reliance on this Bylaw and that the Corporation is estopped to contend otherwise. Additionally, it is hereby expressly recognized that all persons who are Directors or Officers of the Corporation and who also serve as Directors, Officers, or employees of Corporations that are subsidiaries or affiliates of the Corporation (or otherwise entities controlled by the Corporation) are conclusively presumed to serve or to have served as such at the request of the Corporation, and, unless prohibited by law, are entitled to indemnification under this Bylaw. ***(NOTE: Omit the bold, italicized words above if the nonprofit organization is not a membership organization.)***

For purposes of this Bylaw, the Corporation shall be deemed to have requested a Director or Officer of the Corporation to serve an employee benefit plan where the performance by such person of his or her duties to the Corporation also imposes duties on, or otherwise involves services by, such person to the plan or participants or beneficiaries of the plan, and excise taxes assessed on a person with respect to an employee benefit plan pursuant to applicable law shall be considered indemnifiable expenses, and action taken or omitted by a person with respect to an employee benefit plan in the performance of such person's duties for a purpose reasonably believed by such person to be in the interest of the participants and beneficiaries of the plan, shall be deemed to be for a purpose that is not opposed to the best interests of the Corporation.

A person who has been successful, on the merits or otherwise, in the defense of a civil or criminal action or proceeding shall be entitled to indemnification as authorized in this Article. Except as provided in the preceding sentence and unless ordered by a court, any indemnification under this Bylaw, under any contract or otherwise, shall be made by the Corporation if, and only if, it is determined: .

- (1) If there are two or more disinterested Directors, by a majority vote of all disinterested Directors, a majority of whom shall constitute a quorum for such purpose, or by a majority vote of the members of a committee of two or more disinterested Directors appointed by such vote, that the Director or Officer has met the applicable standard of conduct set forth in the first or second paragraph of this Article;
- (2) By special legal counsel selected in the manner prescribed in paragraph (1) above or, if there are fewer than two disinterested directors, selected by the Board of Directors, that the Director or Officer has met the applicable standard of conduct set forth in the first or second paragraph of this Article; or
- [(3) By the members that the Director or Officer has met the applicable standard of conduct set forth in the first or second paragraph of this Article.] (NOTE: Omit this paragraph (3) if the nonprofit organization is not a membership organization.)***

If any expenses or other amounts are paid by way of indemnification, otherwise than by court order or action by the members, the Corporation shall, not later than the next annual meeting of members, unless such meeting is held within three months from the date of such

payment and, in any event, within fifteen months from the date of such payment, mail to its members of record at the time entitled to vote for the election of Directors a statement specifying the action taken, or, if the Corporation has no members, such statement shall be included in the records of the Corporation open to public inspection.

In case any provision in this Article shall be determined at any time to be unenforceable in any respect, the other provisions shall not in any way be affected or impaired thereby, and the affected provision shall be given the fullest possible enforcement in the circumstances, it being the intention of the Corporation to afford indemnification and advancement of expenses to its Directors and Officers, acting in such capacities or in the other capacities specified in this Article, to the fullest extent permitted by law.