

Liability of Volunteer Directors of Nonprofit Corporations (10/02)

This memorandum addresses the California and federal law protections that exist to shield volunteer directors of nonprofit corporations from personal liability for their actions on behalf of the corporation. Please note that the law in this area may change from time to time, and you should review any specific matter with an attorney.

SUMMARY

Provided a volunteer director acts within the scope of his/her duties as a director, does not commit gross negligence or act in wanton or reckless ways, and does not engage in self-dealing; and provided the nonprofit public benefit corporation maintains (or seeks to obtain) liability insurance in the required amount, a volunteer director is significantly protected from personal liability for his/her actions under federal and California law.

DISCUSSION

Directors of all corporations, whether for-profit or nonprofit, are protected in whole or in part by state statute from personal liability for actions taken on behalf of the corporation. Because many nonprofit organizations cannot afford to pay individuals to be directors or officers, they instead rely on volunteers to take on these responsibilities.

Recently, individuals have grown concerned that their volunteer service as a director or officer could result in personal liability. To promote volunteerism, the government has responded by enacting legislation that further shields *volunteer* directors and officers of nonprofit corporations from personal liability for their actions on behalf of the corporation – except in extreme cases.

California Law

Protection Against Liability

1. *General Protection.* Section 5231 of the California Corporations Code sets forth the standards applicable to directors of nonprofit public benefit corporations¹ who seek protection from personal liability. These standards apply whether or not the director is compensated by the corporation.² They are as follows:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

¹ Most public charities operating in California are organized as nonprofit public benefit corporations.

² See CAL. CORP. CODE § 5230.

(b) In performing the duties of a director, a person shall be entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence; or

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(c) Except where the transaction involves self-dealing or an interested director,³ a person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director, including, without limiting the generality of the foregoing, any actions or omissions which exceed or defeat a public or charitable purpose to which a corporation, or assets held by it, are dedicated.⁴

2. *Protection for Small Charities.* In addition to this protection, Corporations Code Section 5239, originally enacted in 1987, offers protection for certain small charities organized as nonprofit corporations when those organizations have an annual budget of less than \$25,000 and are exempt from federal income taxation under Section 501(c)(3) of the Internal Revenue Code. Section 5239 provides that there shall be no personal liability to a third party for monetary damages on the part of *volunteer* directors or *volunteer* executive officers⁵ of those

³ Such transactions are those in which the director has a financial or personal interest that may benefit the director. This memorandum addresses only potential liability stemming from transactions in which the director has no such financial or personal interest.

⁴ CAL. CORP. CODE § 5231.

⁵ To "volunteer," as defined in section 5239, means to "render[] . . . services without compensation." CAL. CORP. CODE § 5239 (b) (West 1990 & Supp. 2000). "'Compensation' means the remuneration whether by way of salary, fee, or other consideration for services rendered." *Id.* However, a director or an executive officer may receive payment of per diem, mileage, or other reimbursement expenses, without such payment affecting that individual's volunteer status within the meaning of this section. *See id.*

nonprofit corporations when the damages are caused by the director’s or officer’s negligent act or omission in the performance of that person’s duties as a director or an officer if:

- (1) The act or omission was within the scope of the director’s or executive officer’s duties.
- (2) The act or omission was performed in good faith.
- (3) The act or omission was not reckless, wanton, intentional, or grossly negligent.
- (4) Damages caused by the act or omission are covered pursuant to a liability insurance policy issued to the corporation, either in the form of a general liability policy or a director’s and officer’s liability policy, or personally to the director or executive officer. In the event that the damages are not covered by a liability policy, the volunteer director or volunteer executive officer shall not be personally liable for the damages if the board of directors of the corporation and the person had made all reasonable efforts in good faith to obtain available liability insurance.

A nonprofit public benefit corporation having an annual budget of less than \$25,000 satisfies the condition that “all reasonable efforts in good faith to obtain available liability insurance” be made if the corporation (1) makes at least one inquiry per year to purchase a general liability insurance policy and (2) that policy is not available at a cost of less than 5 percent of the previous year’s annual budget.⁶ For corporations in operation less than a year, this provision of the Corporations Code applies “for as long as the budget of the corporation does not exceed \$25,000 in its first year of operation.”⁷

3. *Protection for Most Charities and Trade Associations.* Section 5047.5 of the Corporations Code sets forth additional guidance for volunteer directors of a broader category of nonprofit corporations.⁸ This Section specifically prohibits the award of monetary damages against such a volunteer director if certain conditions are met. It provides:

- (b) Except as provided in this section, no cause of action for monetary damages shall arise against any person serving without compensation as a director or officer of a nonprofit corporation subject to [the nonprofit public benefit corporations law] . . . on account of any negligent act or omission occurring (1) within the scope of that person’s duties as a director acting as a board

⁶ See CAL. CORP. CODE § 5239(h) (West Supp. 2000). “An inquiry pursuant to this subdivision shall obtain premium costs for a general liability policy with an amount of coverage of at least \$500,000.” Id.

⁷ Id.

⁸ See CAL. CORP. CODE § 5047.5(c) (West 1990 & Supp. 2000). See also id. § 5047.5(d) (stating that the section only applies to those nonprofit corporations that are exempt from federal taxation under Section 501(c)(3) or 501(c)(6) of the Internal Revenue Code).

member, or within the scope of that person’s duties as an officer acting in an official capacity; (2) in good faith; (3) in a manner that the person believes to be in the best interest of the corporation; and (4) is in the exercise of his or her policymaking judgment.

Section 5047.5 also delineates areas in which the protection will not apply. Among other specific exceptions (such as criminal or tortious conduct⁹ for example), volunteer directors will not be shielded from personal monetary liability when they act in intentional, wanton, or reckless ways, when they engage in self-dealing (including conflicts of interest), or when an action is brought against a volunteer trustee by a trust beneficiary for breach of trust.

Section 5047.5 will only apply, however, if the nonprofit corporation maintains a required minimum level of liability insurance.¹⁰ Unlike Section 5239, whose protections apply so long as the corporation has made a good faith effort to obtain insurance, Section 5047.5 *requires* that a corporation whose annual budget is less than \$50,000 maintain a minimum coverage policy of \$500,000. For those corporations whose annual budget equals or exceeds \$50,000, the insurance policy must provide at least \$1,000,000 in coverage. The insurance policy must also be in force both at the time the injury occurs as well as at the time the claim is made.¹¹ If the corporation does not have such insurance, the protections of Section 5047.5 do *not* apply. In other words, good faith efforts to obtain insurance are *not* sufficient to trigger Section 5047.5. Additionally, Section 5047.5 requires that the claim made against the volunteer director be a claim that may also be brought directly against the corporation.¹²

4. *Procedural Protection for Other Nonprofit Corporations.* Finally, Civil Procedure Code Section 425.15 provides additional protection, in the form of pleading requirements, for actions against directors or officers of nonprofit corporations exempt from federal income taxation under Sections 501(c)(1) (except credit unions), 501(c)(4), 501(c)(5), 501(c)(7), or 501(c)(19) of the Internal Revenue Code.¹³ The protection offered under this section, however, does not apply to Section 501(c)(3) organizations.¹⁴

Section 425.15 states that a cause of action against an uncompensated¹⁵ director or officer based on a negligent act or omission may not be included in a pleading without a court order based on a finding that the party filing the pleading has “established evidence that

⁹ The protections against personal liability for a director acting within his/her official capacity do not bar the liability of the director for tortious conduct. See *Frances T. v. Village Green Owners Ass’n*, 42 Cal. 3d 490, 504 (1986) (“Directors are liable to third persons injured by their own tortious conduct regardless of whether they acted on behalf of the corporation and regardless of whether the corporation is also liable.”).

¹⁰ See *id.* § 5047.5(e).

¹¹ See *id.*

¹² See *id.*

¹³ See CAL. CIV. P. CODE § 425.15(e) (West Supp. 2000).

¹⁴ See *id.*

¹⁵ As in the Corporations Code Section 5239, compensation as defined under the Civil Procedure Code Section 425.15 does not include the payment of per diem, mileage, or other reimbursement expenses. See *id.* § 425.15(d).

substantiates the claim.”¹⁶ The purpose of this provision is to minimize frivolous claims against directors of nonprofit corporations not covered by the above statutes.

5. *Summary.* Under California law, provided that a volunteer director acts within the scope of his/her duties as a director, does not commit gross negligence or act in wanton or reckless ways, and does not engage in self-dealing, and provided that the nonprofit corporation maintains (or, in the case of Section 5239, seeks to obtain) liability insurance in the required amount, a volunteer director of a nonprofit corporation is provided strong protections from personal liability for his/her actions.

Indemnification

Section 5238 of the Corporations Code sets forth both the conditions justifying indemnification and the restrictions on a nonprofit corporation’s power to indemnify its directors. The corporation may indemnify any person who is, was, or is threatened to be made a party to any proceeding by reason of the fact that such person is or was a director¹⁷ of the corporation.

Under certain circumstances, a nonprofit corporation may indemnify a director against expenses, judgements, fines, settlements, and other amounts actually and reasonably incurred in connection with a proceeding brought against the director. These circumstances include (1) when the director is successful on the merits in defense of the proceeding, or (2) when the proceeding is brought by reason of the person’s status as director or for actions taken on behalf of the corporation.¹⁸ However, for indemnification to be justified, the director must

¹⁶ Section 425.15 of the Code of Civil Procedure provides in relevant part:

(a) No cause of action against a person serving without compensation as a director or officer of a nonprofit corporation described in this section, on account of any negligent act or omission by that person within the scope of that person’s duties as a director acting in the capacity of a board member . . . shall be included in a complaint or other pleading unless the court enters an order allowing the pleading that includes that claim to be filed after the court determines that the party seeking to file the pleading has established evidence that substantiates the claim. The court may allow the filing of a pleading that includes that claim following the filing of a verified petition therefor accompanied by the proposed pleading and supporting affidavits stating the facts upon which the liability is based. The court shall order service of the petition upon the party against whom the action is proposed to be filed and permit that party to submit opposing affidavits prior to making its determination. The filing of the petition, proposed pleading, and accompanying affidavits shall toll the running of any applicable statute of limitations until the final determination of the matter, which ruling, if favorable to the petitioning party, shall permit the proposed pleading to be filed.

CAL. CIV. P. CODE § 425.15(a) (West 2000).

¹⁷ Section 5238 uses the term “agent;” however, that term is defined as including, among other positions, any person who is or was an officer or director of the corporation. See CAL. CORP. CODE § 5238(a) (West 1990 & Supp. 2000).

¹⁸ See id. § 5238 (b)-(c). For actions taken on behalf of the corporation, the director may not be indemnified for amounts paid in *settling* or otherwise disposing of an action regardless of whether there is court approval for the settlement, for expenses incurred in *defending* an action that is settled or otherwise

have acted in good faith and in a manner he/she reasonably believed to be in the best interests of the corporation.¹⁹ Except in a case in which the director was successful on the merits in defense, indemnification requires a determination that it is proper under the circumstances because the director has met an applicable standard of conduct.²⁰

Indemnification is restricted in situations in which it would be inconsistent with a provision of the articles or bylaws, a resolution of the members of the corporation, or an agreement in effect at the time of the accrual of the cause of action. It is also restricted if the indemnification is inconsistent with any condition expressly imposed by a court in approving a settlement.²¹

In summary, a nonprofit corporation may indemnify its director when the director is successful on the merits in defense of a proceeding, or when the director is a party to an action by reason of his/her status as a director or for actions taken on behalf of the corporation. In the latter two situations, the director has to meet the further requirements of acting in good faith and in a manner reasonably believed to be in the best interests of the corporation. Except when the director is successful on the merits, a determination must be made (either by the court or by specified members of the corporation) that indemnification is proper under the circumstances.

Federal Law

The federal equivalent to California's protections is found in the Volunteer Protection Act of 1997 (the "Act"). The Act's purpose statement reflects congressional concern that potential volunteers have legitimate fears of frivolous, arbitrary, and capricious lawsuits and are thus discouraged from serving in a volunteer capacity.²² Further, Congress found it to be in the interest of the federal government to encourage such service.²³

The scope and requirements of the Act are quite similar to California's protections but extend these protections to *all* volunteers of all nonprofit organizations, not just directors and officers.²⁴ The Act bars personal liability when the volunteer acts within the scope of his or her duties as a volunteer and any harm caused by the act is not the result of willful misconduct or

disposed without court approval unless there is approval by the Attorney General, or for a matter in which the director has been adjudged liable to the corporation in the performance of his duty (unless the court determines the director is fairly and reasonably entitled to indemnity under the circumstances). See id. § 5238(c).

¹⁹ See id.

²⁰ The applicable standard of conduct is set forth in Section 5238 (b) and (c). See id.

²¹ See id. § 5238(h). Indemnification is also not permitted if the director breaches his/her fiduciary duties to the corporation.

²² See 42 U.S.C. § 14501.

²³ See id.

²⁴ To qualify as a "volunteer" under the Volunteer Protection Act, the director must receive no compensation or other things of value (other than reimbursement of expenses) in excess of \$500 per year. See id. § 14505(6).

other gross negligence.²⁵ The Act does not, however, bar liability when the harm is a result of the operation of a vehicle by the volunteer and such operation requires licensure or insurance.²⁶

Further, if the volunteer is required to be licensed or otherwise certified to perform the duties at issue, the Act will not bar personal liability without appropriate licensure. Also, the Act requires that if a state law mandates liability insurance coverage of personal liability, the Act will only bar personal liability when such insurance coverage exists in the required amounts.²⁷ Because California law does have such a requirement, the federal protections will only apply if the nonprofit corporation has (or, in the case of California Corporations Code Section 5239, has sought) the required levels of insurance.

Finally, the Act also prohibits any award of punitive damages against a volunteer if the volunteer was acting within the scope of the volunteer's responsibilities to a nonprofit corporation,²⁸ absent clear and convincing evidence of willful or criminal misconduct by the volunteer.²⁹

CONCLUSION

Both the California State Legislature and the Federal Government address the liabilities faced by volunteer directors and executive officers of nonprofit corporations. As a result, three sections of the California Corporations Code, one section of the California Civil Procedure Code, and the federal Volunteer Protection Act of 1997 provide protections against personal liability. Provided a volunteer director acts with due care and without gross negligence, and the nonprofit corporation maintains the required level of liability insurance coverage, a volunteer director of a California nonprofit may not be held personally liable for actions taken on behalf of the corporation. Additionally, the nonprofit corporation may indemnify the director when either the director successfully defends the suit on the merits, or the director is a party to the suit by reason of his/her status as director or for actions s/he has taken on behalf of the corporation.

²⁵ See 42 U.S.C. § 14503(a).

²⁶ See *id.* In contrast, California law does not explicitly exclude harms caused by the operation of motor vehicles, vessels, aircraft, or other vehicles for which the state requires licensure and insurance. However, directors are not protected under California law from liability for their own tortious conduct. See *supra* note 9.

²⁷ See 42 U.S.C. § 14503(d).

²⁸ See 42 U.S.C. § 14503(e).

²⁹ See *id.*