

## Risk Management 2

### Risk Management (cont'd)

#### What is the board of directors' role in managing risk?

The primary responsibility of a nonprofit board of directors is to guide the organization in accomplishing its mission. In fulfilling this obligation, the board has a legal duty to use the organization's assets prudently. The assets of a nonprofit vary, but generally fall within one of the following categories: people (board members, volunteers, employees, clients, donors, and the public), property (buildings, facilities, equipment, materials, copyrights, and trademarks), income (sales, grants, and contributions), and goodwill (reputation, stature in the community, and the ability to raise funds and appeal to prospective volunteers). The board's oversight role empowers it to exercise tremendous influence in ensuring that the organization protects and uses its core assets solely to further the goals of the organization.

To discharge its important responsibility for insuring the health of a nonprofit, an effective board provides leadership and direction for an agency's overall risk management program. The board should pay close attention to the risks inherent in its governance activities.

Through the board's failure to act or mistakes, the directors may expose the organization's assets to losses and thus prevent the agency from achieving its mission. When the board takes the lead in protecting the organization's assets, it supports the organization's successful operation. A successful organization helps to ensure the agency's positive impact on the community for many years to come. The principal risk management goals for most nonprofits are:

- Protecting clients, staff, volunteers, and the public from harm;
- Conserving the agency's assets for its community-serving mission; and
- Ensuring that resources are available to compensate individuals harmed by the organization's activities.

The board's position enables it to protect a nonprofit against potential risks by:

- Establishing long-term goals and short-term objectives for the nonprofit's program initiatives, board and staff;
- Measuring performance against established goals and objectives;
- Approving an action plan to meet the organization's goals and objectives, and delegating responsibility for plan implementation to the nonprofit's chief executive;
- Monitoring the plan's implementation;
- Ensuring the availability and proper use of funds to support administrative and program activities through active participation in fundraising programs and the development and monitoring of financial management and fundraising policies; and
- Directing necessary changes in focus and monitoring the impact of these changes.

The board of a nonprofit can contribute significantly to managing risk by paying close attention to hot spots -- the areas most likely to result in claims. By adopting practices that minimize the likelihood of such claims, the board places an organization on the right footing. Suggested practices are outlined below:

1. Carefully select the Chief Executive Officer. The board should make the delegation of responsibility for day-to-day management with care. This care begins with the thoughtful selection of a chief executive officer, commonly called the CEO or executive director. The board's ability to fulfill its legal duties and risk management responsibilities will largely depend upon the competence, skills, and cooperation of the CEO.

In recognition of a range of liability concerns, the board should receive legal advice about recruiting and hiring a chief executive. In addition, if the board decides to negotiate an employment contract with its new CEO, the parties to the contract (the board and the CEO) should both seek counsel.

2. Oversee employment practices. While the board's responsibility for hiring generally ends in the selection of the CEO, its overall responsibility for the employment practices of the nonprofit extend a great deal further. Employment-related actions are the largest source of claims filed against boards of directors under Directors' and Officers' (D&O) insurance policies.

The board's role is not to micro-manage every action taken by the executive director. Instead, the board is acting appropriately and responsibly when it questions whether the agency applies its employment practices consistently and uniformly. The board should also determine if the organization is following the board established employment policies. In addition, members of the board should ask what steps the staff are taking to prevent unlawful discrimination or other actions that could result in agency liability (for example, training of supervisory staff). Lastly, when the directors deem it necessary, they should direct the senior staff to strengthen or revisit such practices.

3. Oversee financial management and fundraising policies. Nonprofit boards are often described as "fiduciaries" entrusted by the public with charitable funds. Few nonprofit board members are experts in nonprofit finance, nor must the organization require financial management skills in prospective board members. To discharge their fiduciary duties and the duty of care, board members must be committed and diligent in reviewing information related to the organization's financial position. After establishing goals and objectives and approving the strategic plan, the board should approve an annual budget. The board meets its financial management responsibility by reviewing financial statements regularly and questioning whether expenditures are consistent with the program priorities and operating policies established by the board. Is the organization on a sound financial footing? Are the staff's revenue projections realistic? Do the financial statements present a clear picture of the financial condition of the agency?

Fundraising is one area in which nonprofit boards are most active at the operational level. Nonprofit board members' ability to raise funds or access potential donors is often considered in their selection. The board's role in managing fundraising and development-related risks includes developing policy for fundraising strategy and practices. For example, does the nonprofit reject unsuitable gifts? Does it have procedures in place to account for the "strings" attached to certain donations? Are policies and controls

in place to ensure that funds will be spent according to the provisions of restricted grants?

4. Review Directors' and Officers' (D&O) coverage. D&O policies have evolved considerably over time to meet the needs of nonprofit organizations. While some nonprofits continue to purchase traditional corporate D&O policies, most select policies that respond to the unique exposures facing nonprofits. Board members should be knowledgeable about the agency's D&O coverage and request information that will enable them to evaluate whether the coverage purchased by the organization is appropriate and responsive to the nonprofit's exposures.

For example, will the insurer advance defense costs or require that the nonprofit pay counsel and await reimbursement by the company after they resolve the claim? Does the policy contain a broad definition of insured or is coverage limited to current directors and officers? Does the policy provide broad coverage for employment practices liability or exclude employment-related claims? Given the growing number of D&O claims (especially employment practices allegations), nearly every nonprofit can benefit from buying a D&O policy. The current competitive marketplace for D&O coverage and most nonprofits' lack of a loss reserve fund also support the benefits of purchasing D&O insurance.

5. Adopt and follow procedures. "Good procedures, regularly followed" could be the risk management mantra for any nonprofit. Several policies and procedures can be invaluable to a board as it strives to fulfill its legal duties and risk management responsibilities. These include the use of position descriptions for board members and an annual self-evaluation process, and the adoption of conflict of interest policies, attendance policies, and board minute procedures.

#### **What are the most dangerous myths about nonprofit liability (or risk management)?**

For many people, nonprofit organizations have a certain mystique. They know that the founders created nonprofit organizations for charitable or educational purposes with the ultimate goal of improving the quality of life. Thirty or forty years ago, nonprofit organizations benefitted from charitable immunity, under which the courts held an organization immune from all tort actions. Charitable immunity was based on the belief that a charity's funds should go toward its good works, not to pay for someone's injuries. Through the years, the courts have abolished charitable immunity and replaced it with the doctrine of respondeat superior. The doctrine states that society may hold an organization liable for the actions or inactions of its employees, volunteers, or other agents, although the charity itself may be faultless.

Well-intentioned people often have certain misconceptions about nonprofits. These same people may work or volunteer for a nonprofit agency and hold responsible positions. However, their lack of knowledge or understanding may jeopardize the organization's success. Due to these assumptions, the organization may not take the appropriate steps to protect itself and its stakeholders from harm. Dispelling the myths described below is a first step in managing a nonprofit's risks.

#### **Myth #1 - Practicing risk management is about buying insurance.**

Insurance is a method for financing or funding certain losses. For most

nonprofits, insurance is a critical component of their risk management program. However, insurance is only a financial bandaid. Nonprofits exist for a variety of reasons and with many different missions. However, their first goal is to do no harm and in some way enhance another's life. Enhancements include introducing disadvantaged youth to the beauty of the arts, improving the environment, providing management assistance to other nonprofits, or finding shelter for a battered woman.

The success of most nonprofits is dependent upon the support of the public either as donors or volunteers. Any misstep -- an auto accident, the abuse of a client, theft of the agency's funds by an employee or volunteer, or other event that brings negative attention to the organization -- can have a lasting impact. Practicing risk management is an effective way to address these issues.

Risk management is the discipline for dealing with the possibility that some future event will cause harm. It provides strategies, techniques and an approach to recognize and confront any threat or danger that may hinder the organization from fulfilling its mission. Insurance is just one of many techniques available to a nonprofit to finance its risks. Organizations must pay for losses somehow and insurance is one method. However, insurance does nothing to prevent a risk from materializing. The least costly accident, in terms of time, money and morale, is the one that does not occur. Risk management goes beyond the purchase of insurance.

## **Myth #2 - Lawsuits against nonprofits are common.**

A popular, common belief is that the legal system is running amok. Many believe that everyone is suing someone and receiving multi-million dollar awards. However, the facts reflect a different reality.

According to a 1988 study by the Insurance Services Office, lawsuits represent less than a third of total liability claims. Approximately 32% of all liability claims involve a lawsuit, while only 2% of all claims are settled by a jury or judicial verdict. An Insurance Information Institute study shows that while the total number of liability claims continues to grow, the growth rate is slowing when measured by the amount paid (in inflation adjusted dollars). In the 1980's, the claims paid amount increased at an average annual rate of 21.2%. The current rate is 7.3%, although the rate is still double the inflation rate.

Corporate managers often follow the "80-20" business rule. For an insurance company, the rule holds that 80% of their losses come from 20% of their policyholders. To extend the rule to the nonprofit sector, 20% of the nonprofit organizations will submit 80% of the claims. Consequently, 80% of all nonprofits may never suffer a loss. Unfortunately, no organization knows whether it will be a part of the 20% that has a claim. One way to reduce the chance of being within the 20% that will have a loss or claim is to recognize and control your risks. Nonprofits work to improve the quality of life, not endanger

it. Therefore, the organizations that attend to their risks by striving to protect and conserve their resources actively, reduce their chance of being in the wrong group.

**Myth #3 - Volunteers are more likely to suffer injuries than clients or employees.**

Many nonprofits are extremely concerned about their volunteers being hurt while working for the agency. A volunteer injury is a risk that an organization should consider, but not to the exclusion of other exposures. Any volunteer can suffer a debilitating or permanent injury from their volunteer activities.

However, a greater risk may be that the volunteer harms another person, such as a client, another volunteer, or employee.

Anecdotal evidence suggests that volunteer injuries are infrequent and minor. Also, volunteers do not appear to get hurt anymore frequently or severely than employees. The low cost of volunteer accident insurance supports these premises. The perception of a high accident rate may exist because the number of volunteer claims may be higher than employee accidents. However, for most nonprofits, the number of volunteers greatly exceeds the number of employees. Clients' injuries require a different perspective. A nonprofit must exercise a certain level of care for its clients. If the organization does not meet that standard and is deemed negligent, it can be held liable for the injury. A negligence claim can be more costly than paying for the medical expenses of a volunteer's minor injury.

Every nonprofit organization should be concerned about injuries to its volunteers. Each agency should take steps to reduce the chance of a volunteer being hurt. However, this is just one of many risks that a nonprofit must recognize and address. Z

**Myth #4 - A "hands-off" approach to managing volunteers provides the best protection against liability.**

The basis of this myth is, first, the belief that a nonprofit organization is not responsible nor liable for the actions of its volunteers. The second part of the myth is that if an agency does manage its volunteers, it accepts responsibility for their actions. Like all myths, these statements contain an element of truth. Under the doctrine of vicarious liability, nonprofits can be found responsible for the actions of a volunteer (or employee) acting within the scope of their duties, even if the nonprofit is faultless.

The courts and society justify vicarious liability on the grounds that the entity that directs and benefits from an individual's actions should bear the costs of any resultant harm. The legal doctrine is respondeat superior ("the master will respond"). The doctrine provides that if a "servant" acts negligently and causes some damage while performing his or her assigned work, the "master" is legally

liable for that damage. Society imposes the liability whether or not the "master" was negligent or at fault in any way.

In order to determine (a) if a "master-servant" relationship existed and (b) if the servant's negligence caused the harm, the courts will consider the following factors:

The degree of control the organization can exercise (whether exercised or not) control over the volunteer;

The scope of the volunteer's position; and

The benefit the organization derives from the volunteer's services.

Whenever the a volunteer is deemed to be a servant, the nonprofit will be vicariously liable for the person's actions. A "hands-off" management approach does not necessarily allow an organization to avoid the creation of a "master-servant" relationship. If anything, the doctrine underscores the need for the organization to oversee and manage its volunteers to reduce the chance of an incident.

#### **Myth #5 - General liability policies cover all of a nonprofit's liability exposures.**

A commercial general liability (CGL) policy covers a nonprofit organization, its directors, executive officers, and employees for those sums the insured becomes legally obligated to pay as damages for bodily injury and property damage. Some insurance companies are willing to provide coverage for others such as volunteers, sponsors, and landlords. Most policies also provide coverage for personal injury (false arrest, libel, slander, defamation and malicious prosecution) and advertising injury (oral or written publications, copyright infringement). A CGL policy will pay for covered damages and the costs to defend against allegations even if the allegations are groundless or false.

The CGL policy covers the operations of the insured, in this case the programs and activities of the nonprofit organization. However, the policy contains exclusions and limitations that may eliminate coverage for some aspects of an organization's operations. The most common exclusions are intentional acts, employee injuries, automobile, watercraft, employment practices, professional liability, and improper sexual conduct. Coverage for some of these exposures may be available through an endorsement to the CGL policy or a separate policy. A commercial general liability policy is rarely the only insurance needed by a nonprofit.

#### **Myth #6 - The Volunteer Protection Act immunizes our volunteers from claims.**

The Volunteer Protection Act of 1997 (Public Law 105-19) preempts state volunteer immunity laws "to the extent that such laws are inconsistent with the Act." The Act does not preempt a state law that provides additional protection, specifically:

The requirement that a nonprofit adhere to risk management procedures;  
Laws that make a nonprofit liable for the acts or omissions of its volunteers to the same extent as employees;  
Provisions that render the immunity inapplicable if an officer of a state or local government brought the civil action; and  
Provisions that limit the applicability of immunity to nonprofits that provide a "financially secure source of recovery," such as insurance.

The Act provides immunity for volunteers serving nonprofit organizations and governmental entities for harm caused by their acts or omissions if:

The volunteer acted within the scope of his or her responsibilities.

If appropriate or required, the volunteer was properly licensed, certified or authorized to act.

The harm was not caused by willful, criminal or reckless misconduct or gross negligence.

The harm was not caused by the volunteer operating a motor vehicle, vessel, or aircraft.

Other exceptions to the liability immunity include misconduct that is a crime of violence, hate crime, sexual offense, and acts committed under the influence of alcohol or drugs. The Act also does not protect volunteers from an action brought against them by the nonprofit. Consequently, a volunteer is still liable for some actions, such as automobile accidents, gross misconduct (reckless endangerment), and any action occurring while intoxicated or under the influence of drugs.

### **What risks are associated with nonprofit fundraising?**

For most nonprofits, fundraising is a required but rarely easy task. As the number of nonprofits and the need for charitable services continue to grow, securing donations and grants is an increasingly difficult and competitive business. While nonprofit fundraisers may feel anxiety about approaching a funder for the first time, or asking a long-time supporter to increase her annual contribution, most pursue these tasks with enthusiasm and creativity.

Fundraising activities, however, can be among the riskiest programs a nonprofit undertakes. The failure to acknowledge and control the risks associated with fundraising efforts can seriously threaten an organization's survival. Therefore, a nonprofit can and should apply risk management techniques to every major component of its operations, including fundraising.

Risk management increases the probability of attaining goals successfully and fulfilling a mission by anticipating challenges and planning alternatives around possible barriers. The nonprofit's range of potential, harmful future events varies. Future "harm" might be a lawsuit alleging wrongful termination, or a long-time funder's insistence that funds be returned.

In many areas of operations, insurance products are available to finance a particular risk. For example, Employment Practices Liability (EPL) policies provide moneys to fund the defense of an employment-related suit and pay settlement or judgment costs. No policy, however, compensates a nonprofit for the return of funds to an unhappy donor or revenue shortfalls due to unrealistic fundraising projections. Insurance, also, does not protect against damage to a nonprofit's reputation following its association with a controversial corporate donor.