D&O LIABILITY

Protection for Unpaid Directors and Officers of Illinois Not-for-Profits: Fact or Fiction?

This article analyzes provisions of and amendments to the Illinois General Not-For-Profit Corporation Act of 1986 that increase the level of fault required to recover damages from an uncompensated director or officer.

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I. Introduction

The Illinois legislature has recently attempted to increase protection from liability for uncompensated directors and officers of certain Illinois not-for-profit corporations. Unfortunately, an unintended result of this legislation may be to increase the monetary exposure of these individuals. Many directors and officers of nonprofits believe that the new law shields them from liability for acts or omissions. That conclusion is not necessarily correct, and directors and officers should be advised accordingly.

In particular, attorneys should advise these corporate officials that directors' and officers' liability insurance retains its traditional importance and may be an additional avenue for protection. For uncompensated directors and officers, even a remote risk of liability is unacceptable. Thus, they should be counseled to seek indemnification to the extent possible and insurance protection if feasible, and because insurance may be unavailable or not fully protective, they should be made aware of their potential liability.

II. A Look at Section 108.70 of the Act

The increased protection from liability for uncompensated directors and officers of Illinois not-for-profit corporations (exempt from tax under section 501(c) of the Internal Revenue Code and organized "under this Act") was enacted in 1986, and is now codified at section 108.70 of the Illinois "General Not For Profit Corporation Act of 1986" ("the Act").[1] Section 108.70(a) of the Act provides as follows:

> No director or officer serving without compensation, other than reimbursement for actual expenses, of a corporation organized under this act and exempt, or qualified for exemption, from taxation pursuant to section 501(c) of the Internal Revenue Code of 1986, as amended, shall be liable, and no cause of action may be brought, for damages resulting from the exercise of judgment or discretion in connection with the duties or responsibilities of such director or officer unless the act or omission involved willful or wanton conduct (emphasis added).[2]

Section 108.70(d) defines "willful or wanton conduct" as a "course of action which shows an actual or deliberate intention to cause harm or which, if not intentional, shows an utter indifference to or conscious disregard for the safety of others or their property."[3]

The language appears to shield directors and officers of qualifying[4] Illinois not-for-profits from liability unless they intentionally or recklessly harm a third party.

Since a corporate official cannot be held liable for a merely negligent act, why would such an official be concerned about liability for acting in that capacity? Moreover, why should a qualifying Illinois not-for-profit corporation maintain directors' and officers liability insurance?

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1. Ill Rev Stat ch 32, § 108.70(a)-(e) (1989).
2. Id, § 108.70(a). Section 108.70(c), passed in 1987, extends this protection to all persons (not just directors and officers) who, without compensation (other than reimbursement for actual expenses), render service to or for an Illinois not-for-profit corporation that is exempt from tax under § 501(c)(3) of the Internal Revenue Code. In addition, reference in the text to the new statute's higher fault standards applies to the increased burden now placed on plaintiffs to demonstrate officer or director malfeasance by proving "willful or wanton conduct."). This article focuses on officers and directors liability exposure.

   See also § 108.70(b), which protects directors of Illinois not-for-profit corporations organized for certain purposes (agricultural, professional, industrial or trade association, electrification on a cooperative basis, or telephone service on a mutual or cooperative basis) and exempt from tax under § 501(c) of the Internal Revenue Code of 1986 for damages from mere negligence unless the director earns more than $5,000 per year from directorial duties (other than reimbursement for actual expenses).
3. Ill Rev Stat ch 32, § 108.70(d) (1989).
4. The term "qualifying" is used to refer to Illinois not for profit corporations that are exempt from taxation pursuant to § 501(c) of the Internal Revenue Code of 1986, IRC § 501(c), and whose directors and officers are as a result provided with increased protection from liability. See notes 1 through 3 and accompanying text.

A hint at the answer and one indication that the statute may not be having its intended effect is that many insurance companies have not lowered premiums for policies covering directors and officers of Illinois not-for-profits since section 108.70 was passed. Many defense lawyers believe that plaintiffs will merely modify their pleadings to meet the new statute's higher culpability requirements and that directors and officers of not-for-profit corporations will continue to face high defense costs for even the most tenuous claim.[5]

Insurance companies may also be concerned that the higher fault standard set forth in section 108.70 is limited and does not apply to or provide protection for a variety of potential lawsuits against directors or officers.[6] Accordingly, insurers may feel that the actual monetary exposure is as great now as before section 108.70.

III. The Risk of Statutory Liability

A substantial shortcoming of section 108.70 is that it is directed primarily at third-party tort claims against corporate officials.[7] As a result, it offers insufficient protection against statutory liabilities. For example, directors may be held liable for a corporation's failure to adhere to its withholding tax obligations. The penalties for such failure can be harsh; the federal government is allowed to place a lien on a responsible corporate official's residence to secure payment.[8] Corporate officials may also find themselves personally liable for failing to pay state withholding taxes.[9]

In addition, a corporate official may also be personally liable if an Illinois not-for-profit corporation fails to collect or pay over state sales and use taxes (provided that the Department of Revenue has not granted the organization state sales tax exemption). Failure to adhere to sales tax requirements may also subject corporate officials to liability.[10]

Further, for not-for-profit corporations treated as private foundations for federal income tax purposes[11] there are stringent requirements against and excise taxes levied on various kinds of self dealing, jeopardizing investments, and other statutorily created malfeasance that could cause foundation managers, including directors and officers, to become personally liable.[12]

Also, there are statutes directed at not-for-profit corporations that may expose directors and officers to civil penalties and even criminal sanctions. For example, the Act provides that filing false information by a director or officer with the secretary of state is a class C misdemeanor.[13] Further, the Act creates potential liability for corporate directors who vote for or assent to improper distributions[14] or who continue to operate a corporation after articles of dissolution have been filed.[15]

These examples are not intended to exhaust the potential statutory liabilities. Rather, they demonstrate that liability may depend on fault that is either i) strict, in that fines or penalties may be levied regardless of whether the director or officer "intended" or "knowingly or recklessly committed" a wrongdoing, or ii) not based on whether the corporate official intended to harm third parties or should have known the acts would cause harm. In that sense, the standard for

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5. For example, consider tort suits against directors for "economic losses." In *Moorman Manufacturing Company v National Tank Company*, 91 Ill 2d 69, 86, 435 NE2d 443, 450, (1982), the court held that a party cannot recover for economic losses under a tort theory; economic losses can only be recovered under a breach of contract theory. Because economic losses can only be recovered under a breach of contract theory, directors and officers should not be exposed to liability premised on economic losses. Corporate directors and officers, regardless of whether in the for profit or not for profit context, generally are immune from liability to third parties arising from the acts of the corporation performed by its employees (as opposed to the acts of the corporate officials themselves). Paul E. Treusch and Norman A. Sugarman, *Tax Exempt Charitable Organizations* (2d ed 1983). Thus, directors and officers should not be liable for damages predicated on the corporation's contractual liability. Id. Nevertheless, plaintiffs may still sue directors and officers for economic loss, and though the directors or officers should not be liable, such individuals should be concerned about defense cost exposure from such suits.

See *Directors' and Officers' Liability*, § 7.54 Ill Inst of Cont Legal Ed (1990) ("*IICLE*"), for a discussion of the high cost of defending claims against directors and officers.

6. See notes 8 through 15 and 21 through 25 and accompanying text.

7. Daniel L. Kurtz, *Board Liability: Guide for Nonprofit Directors* 99-100 (1988) ("*Kurtz*"). The author states that the precursor to Illinois' provision, which is substantially similar to the current provision, is intended to "deal primarily with tort claims." Further, the standard of fault, "willful and wanton," is defined in the Act by reference to tort concepts such as "harm" and "conscious disregard for the safety of others or their property." Ill Rev Stat ch 32, § 108.70(d) (1989). One could construct an attenuated argument that the Illinois provision may not be so limited by its language and, therefore, may have a much broader sweep. However, such an interpretation appears to be inconsistent with other provisions of the Act which provide for different standards of fault when non-third party tort claims are involved, such as derivative suits, discussed in notes 21 through 25 and the accompanying text.

8. IRC §§ 6321, 6672. See also IRS Policy Statement P-5-60, IRM - Administration MT (1218-170) ("When the person responsible for withholding, collecting and paying over taxes cannot otherwise be determined, the Service will look to the president, secretary, and the treasurer of the corporation as responsible officers"), and *R.S. Chappell*, 75 UTSC § 9296.

9. See Ill Rev Stat ch 120, § 10-1002 (1989).

10. See Ill Rev Stat ch 120, § 452½ (1989).

11. See IRC § 509(a).

12. See IRC §§ 4941-4946.

13. Ill Rev Stat ch 32, § 116.10 (1989).

14. Id, § 108.65(a)(1).

15. Id, § 108.65(a)(3).

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imposing statutory liability may be lower, or at least different, than the standard in section 108.70.

The question is whether the higher fault standards of section 108.70 would control in those situations and offer directors and officers protection from liability. To the extent a federal statute has been violated, the answer should be no; unless there is language to the contrary in the federal law, the preemption doctrine should give that law priority.[16]

If a state statute has been violated, the answer is not as clear. The answer would turn on construction of the state statute in question and section 108.70. It is uncertain which statute would prevail, though directors and officers would be wise to assume that section 108.70 will not protect them.[17]

In addition to section 108.70 not protecting against statutory liabilities, directors' and officers' liability insurance may not provide adequate protection in these circumstances. Generally, insurance does not cover fines and penalties or other adverse consequences resulting from an individual's intentional or deliberate wrongdoing.[18] For example, for directors and officers responsible for the self-dealing penalty tax under section 4941(a) of the Internal Revenue Code, or for a foundation manager who refuses to agree to the correction of an act of self-dealing under section 4941(b) of the Code,[19] directors' and officers' liability insurance is generally unavailable.[20]

IV. Derivative Suits

Section 108.70 may also not apply to or protect against director or officer liability in derivative suits.[21] These suits usually arise out of directors' performances of their duties of obedience, care, and loyalty to the organization.[22] A logical reading of the intent behind section 108.70 is that it does not apply to liability based on a director's breach of these duties.[23]

For example, the Illinois Attorney General may allege that a private foundation director breached his or her duties of care and loyalty by causing the foundation to retain or invest solely in stock in a closely held corporation in which the director has an interest.[24] Section 108.70 may fail to provide any protection for this type of derivative suit; moreover, indemnification may be unavailable to a director found liable.[25]

V. Application of Section 108.70 is Uncertain

Another problem with the new legislation is that its breadth and application remain uncertain. To date, there has been no reported Illinois case involving or interpreting any of the provisions of the statute. For example, how will courts interpret the statute's requirement that plaintiffs demonstrate "a course of action which shows...an utter indifference to or conscious disregard for the safety of others or their property?"[26] Will the failure to attend a board meeting (during which the board approved a course of action which eventually, but unintentionally, causes harm) indicate a "conscious disregard"? If the director attended the meeting but failed to vote on an action because he or she reasonably believed it would cause harm, would that director be protected from liability under section 108.70?[27] Will the statute apply retroactively to so-called "occurrences" prior to December 22, 1986, the date it was enacted?

"Many defense lawyers believe that plaintiffs will merely modify their pleadings to meet the new statute's higher culpability requirements and that directors and officers... will continue to face high defense costs for even the most tenuous claim."

Moreover, as noted above, even if corporate officials are not liable for damages under section 108.70, the defense of the most tenuous claims

16. See *Burbank v Lockheed Air Terminal*, 411 US 624 (1973).

17. As a practical matter, because § 108.70 is directed at common law tort suits by third parties against corporate officials, the higher standard of fault required by that section probably will not be applied to statutory violations. Certainly, if the state statute in question is premised on the Act, then the more logical reading of the Act is that the violated statute takes precedence over the standard required by § 108.70. For example, § 108.65, which imposes liability on directors in various situations, reads, "In addition to any other liabilities imposed by law upon directors of a corporation, *they are liable* as follows..." (emphasis added). The implication is that liability is not premised on "willful or wanton conduct" as that term is used in § 108.70, but upon acting in the manner proscribed by that section. See note 23 and accompanying text.

18. See *IICLE* at § 7.65 (cited in note 5). An example of one such policy states as follows: "[The insurer] shall not be liable to make any payment for Loss in connection with any Claim made against the Directors or Officers:...brought about or contributed to in fact by any dishonest or fraudulent act or omission or any criminal act or omission...."

Note that an act, such as self-dealing subjecting an individual to liability under § 4941 of the Internal Revenue Code, though perhaps "intentional" in the insurance coverage or excise tax sense, may not constitute "willful or wanton conduct" as the term is used in § 108.70(d) of the Act.

19. IRC § 4941 (1990).

20. See generally note 18. The policy set forth at note 18 also excludes any loss "based upon or attributable to the Directors and Officers gaining in fact any personal profit or advantage to which they were not legally entitled...."

21. The term "derivative suits" is used to include suits by or on behalf of the corporation, including suits by the Illinois Attorney General.

22. See generally *Kurtz* at 92 (cited in note 7) (noting that derivative suits are "[t]he major source of potential liability for directors").

23. For example, §§ 108.80 and 108.85 of the Act set forth bases of liability of directors and officers. To reason that those sections are subject to the standards set forth in § 108.70 is illogical statutory construction and would interfere with the purposes behind those sections. See also § 108.75(b) of the Act, note 25 (implying that a director can be liable in a derivative lawsuit for negligence).

24. Though diversification of assets held by Illinois not for profit corporations is currently not required by Illinois law (*McCormick v McCormick*, 180 Ill App 3d 184, 536 NE2d 419 (1st D 1989)), and the Illinois Uniform Management of Institutional Funds Act, Ill Rev Stat ch 32, §§ 1101-1110 (1989), the Illinois Attorney General has in the past indicated a willingness to use lack of diversification as evidence in certain cases of a breach by such directors of their duty of care and loyalty. (No reported cases or rulings.)

25. See Ill Rev Stat ch 32 § 108.75(b) (1989) (No indemnification is allowed in a derivative suit if a director is "adjudged to be liable for negligence or misconduct in the performance of his or her duty to the corporation" unless, upon application, the court in which the suit was brought determines that in view of the circumstances the director is "fairly and reasonably" entitled to indemnification.)

26. Id, ch 32, § 108.70(d).

27. For example, § 108.65(b) of the Act provides that a director of a corporation who is present at a meeting of its board at which action on any corporate matter is taken is "conclusively presumed to have assented to the action taken" unless a proper dissent is entered or filed.

may generate substantial legal fees.[28] Although statutory indemnification provisions mandate the organization to pay these fees if a director or officer is successful,[29] this will be of no assistance if the corporation is insolvent or has insufficient funds.

In those situations, only directors' and officers' liability insurance would provide reimbursement of attorneys' fees associated with the corporate official's defense.[30] But as a practical matter, such insurance may not be available. The Illinois legislature must remember that directors and officers of not-for-profit corporations, unlike their for-profit counterparts, cannot pass on the cost of insurance as a cost of doing business.

VI. Conclusion

In this and other regards, section 108.70 of the Act has not provided uncompensated directors of qualifying Illinois not-for-profits with a meaningful shield against monetary exposure. In addition to other safeguards, the statute should provide uncompensated directors and officers who successfully defend themselves with a means to seek reimbursement of attorneys' fees from the party who initiated an action.

Further, the statute should clearly define the fault standard for directors in derivative suits and pragmatically increase the protection from monetary exposure of directors and officers. In the interim, these individuals must understand that the "willful or wanton" culpability standard set forth in section 108.70 may not apply to many of their official actions, and that the statute will not protect them from the high costs of defending themselves against non-meritorious lawsuits.

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28. See note 5.

29. Ill Rev Stat ch 32, § 108.75(c) (1989). Indemnification is allowed in other circumstances (such as certain nonsuccessful defenses) and provisions requiring indemnification in those circumstances should be considered when a board enacts or reviews the corporation's bylaws.

30. The board in this situation should be sensitive to the handling of the costs of defending a claim covered by its directors' and officers' liability insurance policy. In particular, these policies commonly include the costs of defense as part of the insured's "loss" within the meaning of the policy. Thus, the legal fees become subject to the deductible and therefore a burden on the corporation. See generally *Kurtz* (cited in note 7) and *IICLE* at § 7.62 (cited in note 5). An example of such a policy states, in part, "[The insurer] agrees as follows:

> [T]o pay on behalf of Directors and Officers for Loss not exceeding the Limit of Liability.... "Loss" shall mean [and include] damages, settlements and Costs [of defense], Charges and Expenses....

There are further coverage issues to which directors and officers should be sensitive. If both the directors and the corporation are named as defendants, the policy may not cover all defense costs associated with the lawsuit. It may therefore be necessary to allocate defense costs between insured and uninsured parties (i.e., the corporation is not an "insured" under a directors' and officers' liability insurance policy). Further, claims may be asserted against a director that are excluded from coverage, also requiring allocation. See generally *Kurtz*.

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