
DUE DILIGENCE IN AVOIDING RISKS FOR DIRECTORS/LEADERS OF CHURCHES AND RELIGIOUS CHARITIES

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A. INTRODUCTION

Liability risks for directors of charitable corporations can arise at common law and under statute law. A director can be held personally liable for his or her own actions or inactions, as well as jointly and severally with the other members of the board of directors. An overview of director's liability is included in an earlier part of this presentation. This Part discusses several ways in which directors of charitable corporations can help limit his or her exposure to liability through due diligence.

B. DUE DILIGENCE IN THE CHOICE OF CHARITABLE STRUCTURES

The choice of charitable structures for a charity determines the relationship between directors and the charity itself, as well as impacting the exposure of directors to liability.

1. Using Existing Charities as an Alternative to a new Charity

- it may not be necessary to create a new charity if the new charity's purposes can be accomplished through an existing charity
- an existing charity may already be accomplishing the same or similar goals
- however, expanding the charitable activities of an existing charity will increase liability to the existing charity and its board of directors

2. Charities as Unincorporated Associations

- an unincorporated association is simple, fast and inexpensive to establish
- however, an unincorporated association is not a separate legal entity and has no legal status apart from its members
- an unincorporated association exposes its members, as well as its directors and officers to personal liability

3. Charities as Corporations

- incorporating a charity makes it a separate legal entity in its own right
- as a separate entity the charitable corporation can bear liability for its own actions

- members of a corporation are protected from personal liability
- directors of a corporate charity must still meet a high fiduciary standard of care and may also be found liable for negligence

4. Using a Multiple Charitable Corporate Structure

- directors have a duty to protect charitable assets, which duty may include utilizing multiple charitable corporations
- utilizing multiple charitable corporations can help to contain high risk liability activity of a charity in separate legal corporate entities
- multiple charitable corporations are appropriate for charities with high risk operations and/or considerable assets that need protection
- multiple charitable corporations can include parallel foundations to protect existing assets or future fundraising and/or can include incorporated operating divisions to contain liability
- multiple corporations can reduce liability exposure to the charity, but the control of the charity over the charitable activities of the new corporation will be lost unless appropriate corporate control mechanism are put in place, as well as licensing agreements for use of the name and trademarks
- multiple charitable corporations, involve having non-overlapping boards of directors, thereby increasing the number of directors required who are exposed to liability

5. Multi Tiered Provincial or National Charities

- multi-tiered provincial or national charities can be structured through either a single corporation with chapter divisions or multiple corporations for chapters and regional divisions
- a single corporate entity provides simplicity in administration and organization, but involves a greater risk of liability to the charity and to its board of directors
- utilizing multiple corporate structure reduces the risk of cross over liability to member organizations but may not protect from liability to the top tier level of organization

The choice of structure of a charity can assist in reducing directors' liability but will not eliminate exposure of directors to personal liability. Directors will also need to rely upon statutory protection, due diligence, indemnification, insurance and other risk management approaches, in addition to considering choice of structure.

C. DUE DILIGENCE IN RELYING UPON STATUTORY PROTECTION

1. Protection from Third Party Contractual Liability

- applies to charities incorporated under the *Canada Corporations Act* (CCA)
- the combination of s. 21(3) and s. 157(1) provides protection to directors and officers from contractual liability

- a director or officer entering into a contract, agreement, or engagement with a third party within the apparent scope of his or her authority as the agent or servant of the corporation will not be subject to personal liability to any third parties
- however, this statutory protection does not protect against knowingly inducing breach of contract

- the director must still exercise due diligence to ensure that the corporation fulfills the terms of the contract
- the protection does not apply to charities incorporated under the *Ontario Corporations Act*

2. Protection from Conflict of Interest

- Federal corporations - sections 98 and 157(1) of the CCA
- Ontario corporations - sections 71 and 133(1) of the *Corporations Act* (Ontario)
- all of these provisions afford some protection from the more stringent requirements under common law regarding conflict of interest
- common law prohibits directors being in any in conflict of interest or other breach of their fiduciary duties in their position as quasi trustees
- the statutory provisions state that if a conflict exists, the director must declare the conflict of interest at the meeting of the board of directors and not participate in any discussion or vote, but otherwise may stay on the board of directors
- however, directors of a charity cannot stay on the board if a conflict of interest continues even though there had been compliance with the statutory provisions to declare a conflict of interest

D. DUE DILIGENCE IN OPERATIONS

Exercising due diligence is the most effective way for directors to protect themselves from liability. Due diligence includes utilizing the rights and powers of the director and seeking professional advice when necessary. However, it will not provide a defense for all statutory violations, i.e. failure to comply with the anti-terrorism legislation.

1. The Rights and Powers of a Director in Exercising Due Diligence

(a) Corporate Authority

- corporate authority is vested in the directors so that they can fulfill their duty to manage the operations of the charity
- directors should know the governing documents of the charity
- certain actions may require special authority from the membership, or may require approval of governing authorities, i.e. Public Guardian and Trustee or CCRA
- may need to amend letters patent and/or bylaws to ensure that there is the appropriate corporate power

(b) Management Access and Control over the affairs of the Corporation

- directors are responsible for all aspects of the operations of the charity and therefore must not limit their involvement to policy review only
- directors have the right to access the property of the corporation to inspect and copy the books, corporate records, and any other documents in order to fulfill their duties
- directors have the right to inspect the physical property owned and/or used by the corporation
- directors have control over the charitable property and the assets of the corporation, including intellectual property
- directors need to utilize the corporate power and rights afforded to them in order to exercise due diligence

(c) Protection of Charitable Assets

- directors have various powers, as well as duties, over charitable property and finances, including the power to:
 - § purchase or acquire assets to carry out the purposes of the corporation
 - § purchase, lease, acquire, sell or otherwise deal with real or personal property, and the power to invest and deal with the monies of the corporation
 - § invest the assets of the charity (in accordance with the prudent investment standard under the *Trustee Act*)
 - § borrow money on behalf of the corporation if the corporation has passed a bylaw authorizing them to do so
- directors must maintain an active role in protecting the assets of a charity
- directors need to take an inventory of charitable assets and keep it up-to-date on an annual basis
- inventory should also include the intangible assets of the corporation, such as intellectual property, name and goodwill of the organization, etc.
- directors can protect the intangible assets of the charity through means such as trademark protection, licenses, business name registration, domain name protection
- review the charity's insurance policies (discussed below) and contracts to ensure that the charity's assets are adequately protected not defined
- consider using multiple corporations to protect assets of the charity

(d) Fundraising

- see article "Looking a Gift Horse in the Mouth" at www.charitylaw.ca
- review the fund-raising strategy and sponsorship arrangements of a charity to eliminate major risks (ie. agency relationship, void for public policy, anti-terrorist legislation, compliance with statutory requirements – fundraising acts like *Charitable Gifts Act* (Ontario), *Religious Organizations' Lands Act* (Ontario), *Charities Accounting Act* (Ontario), but also *Income Tax Act*, *Competition Act*, *federal Privacy Act*)
- directors need to ensure the fundraising costs are reasonable and that the charitable property received is used for intended purposes
- review the terms of any gifts, especially endowments, testamentary provisions, and other restricted gifts, and ensure that such restrictions are complied with and recorded as such in financial statements of the charity

- directors need to take a productive role in monitoring employed fundraising staff and/or third party fundraising companies

(e) Notice/Attendance at Meetings/Minutes

- attendance at meetings of the board of directors is the primary means for the directors to exercise their power to manage and administer the affairs of the corporation
- each director has a right to receive proper advance notice of all board meetings
- a minimum of 14 days' notice is recommended
- each director has the right, even the duty, to attend board meetings
- a director should review the minutes and any financial statements presented in any meeting(s) he or she is unable to attend and voice their objection to any information contained in them
- the right to participate in meetings is limited only by the over riding common law duty for directors to avoid a conflict of interest

(f) Right to Vote

- directors have the right to vote at meetings of the board of directors
- all voting rights must be equal
- the right to vote is a basic entitlement, but is subject to directors' fiduciary duty to avoid any conflict of interest in a contract or proposed contract
- an opposing vote by a director should be recorded in the minutes of the board meeting to provide evidence of directors' position in the event of future litigation against directors

(g) Appropriate Delegation

- day-to-day operations can be delegated to management
- certain decisions can be delegated to committees
- however the directors must exercise supervision and control over delegated activities given to committees or management

2. Policies and Procedures in Achieving Due Diligence

(a) Establishing and Following Policy Statements and Procedures

- directors should be actively involved in hiring senior management and in developing policies and procedures for staff, volunteers and board members
- directors should ensure that policies are being followed consistently, otherwise a policy on paper but not in practice can be more dangerous than no policy at all
- policies and procedures may provide some protection from risks in the areas of sexual harassment, sexual abuse, lifestyle issues for religious charities, third party property use, counseling, bullying, etc.

(b) Screening Procedure

- along with adopting policies to avoid abuse, an appropriate screening process is an important protection against the increase in abuse claims
- screening involves utilizing appropriate questions, interviews, reference of employees and volunteers together with police checks when individuals will be dealing with children

(c) Training/Education

- directors should maintain their skills and knowledge in the area of the charity's current operation
- directors need to educate themselves about changes in legislation and case law affecting directors' duties
- directors need to ensure that senior management are also kept adequately informed on current legal issues

(d) Utilizing Due Diligence Checklists

- general liability checklist (see Schedule "A" attached)
- sexual abuse checklist
- fundraising compliance due diligence checklist
- anti-terrorism due diligence checklist

3. Reliance on Professional Advice in Achieving Due Diligence

In certain circumstances, it will be necessary for the directors to obtain advice from qualified professionals, which can assist in insulating directors from liability.

(a) Management

- the day-to-day operations of a charity usually require employees with particular expertise in the area of the charity's operations
- directors are entitled to rely on assistance and advice from management to the extent that it would be prudent for them to do so
- directors must remain responsible for activities delegated to management
- it is essential that the board of directors receive and review reports from management at each meeting

(b) Outside Professionals

- special instances where professional advice may be necessary are situations requiring legal, accounting or financial expertise
- directors of charities are now permitted to seek the advice of investment professionals in investing charitable property, provided it is prudent to do so

- delegation of investments decision making requires agency agreement and investment policies mandated by the *Trustees Act*

E. DUE DILIGENCE IN INDEMNIFICATION AND INSURANCE

Indemnification and insurance can help cover the financial implications for a director in a situation where he or she actually faces liability. Until 2001, a charitable corporation in Ontario was not permitted to indemnify its directors or officers without seeking prior approval from the courts. This now has changed as a result of amendments to the *Trustee Act*.

1. Statutory basis for Directors and officers Insurance and Indemnity

- under section 93 of the CCA and section 80 of the Ontario *Corporations Act* a not-for-profit corporation may adopt a bylaw to provide indemnity or insurance for its directors
- this right did not extend to Ontario charities unless they obtained a court order
- reg. 4.01 under the *Charities Accounting Act* extended the right to obtain indemnity or insurance to Ontario charities if they comply with certain requirements (see Charity Law Bulletin No. 4)
- before purchasing director and officer liability insurance or authorizing an indemnity, directors must consider the following questions
 - § what is the degree of risk to which a director is exposed?
 - § can the risk be reduced other than by insurance?
 - § what is the cost of insurance in relation to the risk?
 - § what is the cost of insurance in relation to the revenue available?
 - § does the indemnity or the purchase of insurance advance the administration and management of charitable property?

2. Corporate Indemnification

- corporate indemnification provides compensation for the following:
 - § legal fees
 - § fines that were paid under a statute
 - § a financial settlement that result from a lawsuit
 - § any other obligation that a Director was required to fulfill
- corporate indemnification provisions may be of limited assistance
- indemnities are limited to the costs, charges, and expenses that a director might incur from any action, suit, or proceeding brought against him or her for any act deed
- indemnities are only as good as the financial stability of the charity

3. Insurance Consideration

- Policies that a charity should consider obtaining include:
 - general liability insurance
 - directors' & officers' insurance
 - sexual abuse and/or harassment
 - insurance for particular risks, ie. counselling, non-owned auto, third-party use of property, etc.

- The board must consider numerous factors to ensure that insurance is adequate to protect the charity and its directors
 - how much coverage does the policy provide for?
 - does insurance cover all past and present directors, officers, and committee members?
 - is coverage on a “claims made basis” or on an “occurrence basis”?

 - are there exclusionary clauses that limit the protection offered by the policy, such as sexual abuse?
 - are there geographical limits to the coverage?
 - insurance will likely not provide coverage for actions by public authorities for breach of trust, improper investments, or violations of the Anti-terrorism Act or other similar strict liability legislation

- To ensure adequacy of insurance coverage, the insurance agent and/or the insurance should be advised in writing of all activities and risks of the charity on an annual basis, and then asked to respond in writing to the following questions
 - what risks that have been identified are covered?
 - who is covered under the policy?
 - what is the amount of the coverage?
 - what risks are not covered?
 - what additional insurance should be obtained by the charity?

F. DUE DILIGENCE IN OTHER MEANS OF REDUCING RISKS

1. Legal Risk Management Committees
 - directors should establish legal risk management committees to conduct the reviews mentioned above and identify risk areas
 - these committees should conduct a comprehensive audit of the charity’s assets, structure, legal relationships (contractual and non-contractual), and particularly activity-related risks
 - committee should advise the board on implementing due diligence and risk management procedures
 - see attached Schedule “B” for sample Legal Risk Management Checklist

2. Independent Legal Advice
 - directors should obtain independent legal advice in situations where they may be facing a high degree of exposure to personal liability
 - before considering resigning from the board, a director should obtain independent legal advice

3. Size of the Board
 - reducing the number of directors will help to reduce the number of individuals who will be exposed to liability

- a smaller board gives the directors more effective control over the management of the corporation's affairs
4. Committees and Advisory Boards
- utilize committees to do the legal work, but without exposure to the board
 - utilize advisory board to seek input but without directors liability
 - both committees and advisory boards must report and be accountable to the board of directors
5. Transfer of Assets
- no pro-active or due diligence steps can completely shield a director from all potential liability
 - transferring directors' personal assets to their spouses in advance of joining the board can help shield the assets in the event of a finding of liability

For more information and resource materials on Director Liability and Procedure Risk Management see: www.charitylaw.ca, www.antiterrorism.ca and www.carters.ca.

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Schedule “A”
(excerpt from *Directors Primer* by Industry Canada)

RISK PROTECTION CHECKLIST

SUBJECT	TO BE CONDUCTED BY	HOW OFTEN	COMMENT
1. Due diligence	Full board	Annually	At the time of the decision or transaction Have the requirements of due diligence been met before a particular decision is taken or particular transaction is entered into?
2. Screening	Full board	Annually	Are the corporation’s screening practices appropriate in light of our current operations? What is the mechanism for monitoring implementation of the screening, and is this adequate?
3. Reliance on management	Full board	Annually	Is there adequate and on-going supervision management in light of the responsibilities that have been delegated to them?
4. Reliance on experts	Full board	At the time of the decision or transaction	Is the board satisfied with the expert’s credentials and with the quality of the work or advice? Has the board carefully weighed the expert’s input, and then taken an independent decision on the issue?
5. Indemnification	Full board	Annually	Do the corporation’s bylaws provide for indemnification, and does that indemnification accord with the requirements of the incorporating legislation? If the corporation is a charity, is the indemnification authorized by statute or a court; if not, what steps (e.g., obtaining a legal opinion) has the corporation taken prior to providing indemnification?
6. Insurance, general	Full board	Annually	Does the corporation have adequate and appropriate insurance coverage, considering its mandate and activities. What are the scope and limitations of the insurance policies it has in place?
7. Insurance, directors and officers liability	Full board	Annually	Does the insurance coverage extend to committee work by board members, and/or to committee work by non-board members? Does it cover individuals who may be involved in corporate governance even through they do not sit as board members – i.e., advisory bodies? If not, is insurance necessary and provided for in these instances?
8. Other measures to reduce liability	Full board and individual directors	Annually	Have the directors as a group, and as individuals, taken all possible steps to reduce their exposure to liability?