A. LIABILITY: THE LIMITS

You will recall we noted that one major reason for incorporating was to limit liability. And indeed, incorporation does have the special advantage of "limiting" the liability of members of the corporation. Members, directors and officers are not liable, simply by virtue of their membership or leadership, for debts and liabilities of the corporation. Thus, if the corporation is liable for $1,000,000 for injuries caused by its negligence to a person injured on its premises, the corporation's assets may be claimed to pay the debt; but not the personal assets of Mrs. Smith, a faithful member of the church who had nothing to do with the accident, or the personal assets of Rev. Phelps, the pastor.

Notwithstanding this very important limit, churches should understand that not ALL liability is gone merely because the church incorporates. What liabilities remain? First, the corporation itself remains liable; and second, individuals acting for the corporation may become liable in special situations.

B. CORPORATE LIABILITY

1. A church does not reduce its liability through incorporation

A corporation (in this case, the church) itself remains liable for its debts or, as in our illustration, for injuries caused by its negligence. The church still must pay, and all the church's assets are theoretically available to a creditor or someone who has obtained a judgment against the church. This liability of the church is the same whether the church is incorporated or not.

Incorporation is intended to result in limited liability for directors, officers and members, but does NOT reduce the liability of the organization itself.
2. Corporate Liability Through Acts of Agents

The corporation usually acts through persons. Many individuals act for the corporation including directors, officers such as the pastor, employees such as a church secretary, day care staff member or janitor, and even volunteers such as a youth group leader.

Whenever these persons are acting on behalf of the church, acting as what the law would call "agents" of the church, then the church is responsible and potentially liable for their acts. Thus, you can see that the church not only acts when it formally passes resolutions, but when its leaders, employees or others working for the church "act." Even if these persons do something the church does not endorse or even told them not to do, the church may be liable. For example, if an adult volunteer agrees to take the youth group to camp and drives negligently, or at camp is negligent in a supervisory role with the youth group, the church (in addition to the volunteer) may be held liable because she was acting FOR the church. Or suppose the church permits someone who they knew has a questionable driving record to take the children to the mountains and there is an accident with injuries? The church may be liable for negligence in selecting or permitting the driver to take the children. Again, this kind of liability would exist whether or not the church is incorporated.

Of course, not everything an employee or church volunteer does is FOR or at the behest of the church. The legal test is whether the "agent" was acting "in the course and scope of employment" or was acting solely in their personal capacity. Naturally, what the chairman of the deacons or the pastor does solely on their own does not create liability for the church. But as you can imagine the issues often become very complex and there are increasing numbers of lawsuits over these matters. Suppose, for example, the church secretary drives to the post office to pick up the church mail, but decides to swing by the local grocery for some lunch meat, and on this side trip negligently hits another car, seriously injuring all the passengers. Could the church be liable?

3. How can a church protect itself from this liability?

Of course a church should be careful in choosing and supervising employees, but even under the best of circumstances, accidents may happen. And, of course, even if you're in the right, you can still be sued in which case legal fees can be significant even if the church is ultimately successful in denying liability.

There is really nothing that can assure a church will not be legally liable for some acts or omissions. But if the church can't stop liability, it can attempt to assure that its potential liability will not financially devastate the church. How? Insurance.

It is crucial that churches carry general liability insurance to cover the costs of legal defense and of claims against the church. Not all insurance coverage is equal. It is important that churches clarify with their insurance agent and review carefully the language of the policies to assess the scope of coverage. Written clarifications should be requested of unclear
provisions. Some questions to ask are these: What kinds of liabilities are covered? What are the limits? Exclusions? Does the policy provide for the legal defense of claims? Does it cover acts of directors? officers? employees? volunteers?

C. INDIVIDUAL LIABILITY RELATED TO CORPORATION

1. Liability of the Persons Who Acted Wrongfully

Where an employee, volunteer or other person acting for the church (or on their own), commits some wrongful act, such as negligently hitting another’s car or defaming a person, not only may the church be liable, but the individual who commits the wrongful or negligent act is ALSO liable. Incorporation does not affect or protect persons from personal liability for their own acts!137

2. Other Special Situations

We noted in chapter 1, several other contexts in which individuals might incur personal liabilities.

3. Liability of Leaders: Directors and Officers

One of the major advantages of incorporation is limiting the liability of directors as well as other members. However, under some circumstances, church leaders like other corporation or association leaders may be personally responsible for acts in their official capacities. This is actually very rare in nonprofit contexts and almost unheard of in churches, but it is possible. This is the case only, however, where the directors have failed to carry out their duties as directors.

There is a legal principle which is very analogous to biblical concepts of stewardship, and it basically asserts that persons who serve as directors and in certain other leadership roles have a special position of trust, and are obligated to carry out their responsibilities on behalf of those whom they serve. We might say they must be "faithful." The law has described some of these duties.
a. Duties of Church Directors: To the Church

1) Duty of obedience

This duty requires corporate directors to carry out the purposes of the organization as expressed in its Charter and bylaws. They may not act contrary to the mission of the church, and the members and donors of the church rely on these leaders to faithfully carry out the church’s purposes.

2) Duty of good faith and care

A director is required to perform his duties in good faith in a manner he reasonably believes to be in the best interests of the corporation, exercising the care of an ordinarily prudent person in similar circumstances. Good faith means honesty of intentions, openness and fair dealing.

The care of an ordinary prudent person means the director is expected to exercise sound practical judgment and common sense. It does not mean every decision has to turn out to be successful or "right," but that the decisions were not careless. Exercising due care means a degree of diligence about the task of directing and an alertness to potential problems. Certainly "care" requires all directors to be active and functioning members of the Board.

3) Duty of Loyalty

A director is not, to use a biblical phrase, to be "double minded" about their role as church leaders, but to give undivided allegiance to the church’s mission when using the power of his position, its property or information he possesses concerning the church. Directors have a duty to act for the good of organization rather than for their own benefit. This is reinforced by the Internal Revenue Code. Certain provisions in state law are expressions of the same principle. In North Carolina, for example, loans from the corporation to directors and officers are forbidden.

There are strict limits on any "self-dealing" to assure that the corporation is not taken advantage of for the personal benefit of the director. Wherever there is any potential conflict of interest between the interests of the church and the personal interests of a director (whether for himself or some close family or associate), two things are especially important. First, that there is full disclosure to other directors of the personal interests of any of the directors; and second, that interested directors do not vote on any matters in which they have a personal interest. Suppose, for example, that a director-deacon is also a businessman who has an interest in the heating contract for the church building, or has a one-third interest in a paint company and the church is considering where to purchase paint. The director-deacon must reveal his personal interests and avoid voting on who gets the contract for the work.
b. Liabilities from these duties to the church

Director liabilities arise from a breach of these duties of obedience, care and loyalty. These duties are duties to the church, and may usually be enforced only by those with a special interest in the church's affairs such as other directors and officers, or by the state's Attorney General. Members, generally, cannot seek judicial redress for such violations of directors.

Where cases have arisen in this type of context, it has usually been where one group of directors, or perhaps members, accuses the majority directors of self-dealing, or wasting the organization's financial resources through foolish investments or overextended debt. The complaint is that the directors were negligent, or even grossly negligent, in providing leadership to the corporation and because of that, the corporation and its members have suffered.

Where the directors have been found liable in these cases, they are, generally, liable as a group for any wrongdoing which arises as a result of a breach of these duties. This is legally known as "joint and several" liability which means each member is individually liable for all the harm done because of the failure of the directors. Only a director who has objected to improper acts or failure to act can escape liability. Thus, a member of the Board of Directors who objects to some act the majority is pursuing should formally register his objection and be sure the minutes reflect his opposition.

Remember, we are only referring now to the special situation where directors have failed to exercise reasonable care, and not to general liabilities of the church corporation for which the directors would have no personal liability at all.

In "real" life, these liability problems rarely emerge in church contexts. Indeed, this author is not aware of any case which has held local church leaders liable under these principles of law.
c. Director and Officer Liabilities to Outsiders

While there is considerable protection for directors of churches and other corporations, they are not immune from liabilities to outsiders. While it is not possible to be exhaustive here, we note a few more common areas of questions or problems.

1) Directors and Officers are NOT liable for obligations arising from contracts of the church or for the church's debts or other obligations. The corporate form protects them from this liability unless, for example, they personally guaranteed a loan or were involved in some misrepresentation that resulted in the debt.

2) Directors could be liable in connection with their church duties for any wrong they personally participated in. This is especially so in cases of tort law. If the director in carrying out church duties is personally negligent and damages the person or property of another, he may be personally liable.

3) Any involvement in criminal acts or otherwise unlawful acts, even when acting in his capacity as a church official, may lead to personal liability for those acts.149

4) Some government regulatory schemes impose individual responsibility if they are not complied with. This is especially the case in the taxing area with obligations to withhold taxes, pay sales taxes and the like.150

3. What can be done about these personal liabilities of directors and officers?151

Who will be willing to serve as a director or officer if this kind of liability becomes a serious problem?152 Fortunately, churches have rarely found themselves in situations where there directors or officers have become personally liable. In most churches, the sorts of activities of officers and directors are simply not of the type likely to create much serious risk of liability in this area. But it is not impossible even in small churches. Certainly in churches with large budgets, staffs, and programs, the liabilities could potentially become serious, though there is little history of church leader liabilities to warrant major concern.153

Two approaches are available to help protect director's and officer's against personal liability: insurance and indemnification.
a. Insurance Protection

Corporations including churches can secure insurance coverage usually called "Directors and Officers Liability Insurance" or D & O insurance. These policies typically reimburse the corporation for any indemnification payments (see below) made to directors and officers and also make payments directly to such covered persons when they are not protected by the indemnification requirements of the corporation. This insurance is NOT intended to cover corporation liabilities which are covered through its general liability policies. The protection is typically broad but does not protect against willful wrongdoing, nor against impermissible self-dealing, nor are fines or penalties covered. Note, however, that churches may find such insurance either unavailable to them or prohibitively expensive.

Here also insurance coverage varies widely, and any policy should be carefully reviewed. Consider these questions:

- What does the application require in way of disclosure of probable claims?
- Which officers are insured, which not?
- Are retired or replaced directors or officers included?
- Are punitive damages included?
- Does the policy provide defense against false and fraudulent allegations?
- Who controls the legal defense?
- What legal fees are covered? Are they subject to a deductible? Are they included within the overall ceiling of coverage?
- If the organization is also defending the action as a separate defendant, how are costs allocated?
- Are costs advanced?
- Are acts which occurred during coverage covered even if claims are made later? What period for acts which occurred prior to coverage?
- What kinds of actions are excluded from coverage? [Typically policies will not cover such claims as pollution, discrimination claims, failure to secure adequate insurance coverage, or allegations of using office for personal gain.]

b. Indemnification

Statutes in most states including North Carolina permit the corporation to indemnify (reimburse their directors and officers against expenses and liabilities incurred in defending a law suit, civil or criminal, involving their services to the corporation. The corporation may indemnify them for such costs, provided they are not found guilty of gross or willful misconduct.
Prerequisites or Conditions for Indemnification

In almost all cases, in order to be entitled to indemnification even where permitted or otherwise required by law, the director or officer must have acted in good faith and not against the interests of the corporation. Thus, indemnification is normally not available where the duty of loyalty has been breached. In criminal actions, indemnification is sometimes permitted where the person had reasonable cause to believe their conduct was not a law violation.

In actions by outsiders, this indemnification is mandatory where the director or officer employee or agent successfully defends on the merits the charges against him, but generally is discretionary with the corporation if the person is not wholly successful.\textsuperscript{157}

Bylaw provisions may include commitments to indemnify directors and officers in these contexts. Indemnification agreements may also be contained in individual agreements or employment contracts with individuals.\textsuperscript{158}

In actions brought against such a party alleging violation of his duties to the corporation itself, indemnification for the expenses of his defense, including attorney’s fees, is mandatory if the party successfully defends the action or, even if unsuccessful, if a court finds that the person acted “honestly and reasonably” and that, in all the circumstances, his conduct merits such relief.\textsuperscript{159}

Advantages and Disadvantages of Indemnification

The advantage of indemnification to directors and officers is, at least theoretically, to remove some of the threat of financial liabilities connected with defending lawsuits against them in connection with their official duties. Further, indemnification may reimburse directors for some expenses such as fines and penalties that would not be covered by insurance. Indemnification usually also will cover defense investigation costs which might not be covered by insurance.

The disadvantages for the director of indemnification alone, without corporate insurance, are several: first, the corporation may not have the funds to cover the costs even it wishes to; second, there are significant gaps which are usually not covered by indemnification provisions such as the fact that the corporation may, where it has discretion, choose not to reimburse. And for the corporation, indemnification means further potential cost liabilities to the corporation.
c. Statutory Relief

A number of states have provided some relief by entirely eliminating or sharply reducing the exposure of uncompensated directors of nonprofit organizations. New York, Delaware, Minnesota, Rhode Island, Pennsylvania, New Jersey, Ohio, New York, and Illinois have enacted such changes, but no such provisions are now applicable in North Carolina.

4. So what should churches do?

These observations about potential liabilities of directors and officers are not intended to "scare" church leaders. Nor do they reflect any new liabilities not presently shared by churches whether incorporated or not. They are noted here for two principal reasons: first, to make clear that incorporation does not remove all liabilities; and second, to provide some overview of possible liabilities so that churches can make careful decisions about liability insurance. While few churches have chosen to obtain D&O insurance, and liability in that area for churches seems small, general liability insurance to protect the corporation is increasingly important. Churches that do not adequately cover their liabilities not only take serious risks with the church's resources, but may find themselves without sufficient resources to cover injuries to others for which they may be morally and legally responsible.
Notes

137 Where both the individual and the organization are potentially liable, an injured party may see who has the "deep pocket" - financial resources including insurance - in weighing who to go after. Of course both may be sued.


139 Trustees of Rutgers College v. Richman, et al., 41 N.J. Super. 259, 125 A.2d 10, 26 (1956). This also includes a duty to act consistent with the law and to develop organizational systems which assure basic law compliance. For example, the duty extends to withholding and employment tax requirements. Rev. Rul. 84-83, I.R.B. 1984-24; Hildebrand v. U.S., 563 F. Supp. 1255 (D. N.J. 1983).

140 Virginia Mason Hospital Ass'n v. Larson, et al. 114 P.2d 976 (1941).

141 The specific degree of diligence, skill and care required of directors in any specific instance will depend on a wide variety of circumstances including the character of the organization, its size, financial resources, specific matter at issue. For example, the duties of church leaders supervising a 10 million dollar building program, a day care and nursing facility will be quite different than that required of those leading a small rural congregation. The standard will be the same, but reasonable care in those circumstances would understandably be different. For a discussion of standards of liability of directors of nonprofit corporations see, Comment, "The Nonprofit Director's Fiduciary Duty: Toward a New Theory of the Nonprofit Sector," 77 Northwestern University Law Review 34 (1982). The author notes "Not only are the standards of liability poorly defined, but courts often confront a serious problem in determining who may bring suit to enforce these standards. Since most nonprofit corporations benefit the public rather than a specific individuals, it is difficult for a particular person or class to attain standing to sue. Moreover, because stockholders are nonexistent in such corporations and the membership connection -- if members exist - is tenuous at best, members of nonprofit corporations may not have standing either. In such a situation the attorney general is usually responsible for enforcement against wrongdoing." Many states including Illinois have recently enacted modifications to state statutes limiting liability of unpaid directors of non-profit corporations to instances of gross negligence. No N.C. case specifically has addressed the standard of care for nonprofit directors.

142 Ray et al. v Homewood Hospital, Inc. et al., 27 N.W.2d 409 (1947).

143 In Mountain Top Youth Camp, Inc. v. Lyon, 20 N.C. App. 694, 202 S.E.2d 498 (1974) the court held that while self-dealing is not automatically void since it may be approved by disinterested directors, it is void per se when there has been no disclosure, and even fairness is no defense.


145 § 55A-18 which further provides that directors who vote to approve such loans and officers who participate in the making of such a loan are personally liable to the corporation until the loan is repaid.

146 Courts, including North Carolina's, have frequently enforced this loyalty principle and have imposed requirements of disclosure and fairness. This legal rule seems to reflect sound moral principles that the church should happily endorse. Fowle Memorial Hospital Co., v. Nichols, 189 N.C. 44, 126 S.E. 94 (1925); Mountain Top Youth Camp v. Lyon, 20 N.C. App. 694, 202 S.E.2d 498 (1974).

147 § 55A-50 grants the Attorney General authority to bring actions for involuntary dissolution of the corporation. § 55A-51 imposes a duty on the Attorney General whenever he has reason to believe the case "involves the public interest." State law also provides the Attorney General powers to bring an action against trustees when "there is reason to believe the property has been mismanaged through negligence or fraud." §§ 36A-48.
Liabilities

148 See Note, "The Nonprofit Corporation in North Carolina: Recognizing a Right to Member Derivative Suits, 63 N C L. Rev. 999 (1985). There is presently no right of members of a nonprofit corporation to bring a legal action against the directors for violation of these standards, though legislation amending the Nonprofit Corp Act to permit such a right has been proposed by General Statutes Commission and was introduced in 1985 in the General Assembly. Some states have amended their Nonprofit Corporation laws to permit member suits, e.g. N.Y. and Calif (Cal. Corp. Code §§ 50000-10841 (West Supp. 1985)). But California exempts religious corporations from this on first amendment and policy grounds.


151 Officers' liabilities are similar as director's but not as great since they do not have general management responsibilities, but more narrow and specific roles. Their duties relate to the specific duties they have as officers.

152 As one commentator noted, "to ask the individual to assume expenses for consequences of gratuitous services is not to encourage participation." Brown, "The Not-for-Profit Corporation Director: Legal Liabilities and Protection," 28 Fed'n Ins. Counsel Q. 57, 75-76 (1977).

153 The recent cases asserting clergy malpractice liability on the part of a pastor and church (Nally v. Grace Community Church) and the trial court award of $390,000 against the lay leaders of a Church of Christ for its church discipline (Guinn v. Collinsville Church of Christ) do suggest that liabilities potentially exist for every church.

154 Authority to purchase such insurance is provided in § 55A-15(A)(10).

155 The statute permits corporations to advance funds for defending actions so long as the defendant agrees to repay any advanced funds if it should turn out they are not entitled to indemnification. § 55A-17.1(d).

156 § 55A-15(a)(8) and § 55A-17.1-17.3 provides for indemnification of officers and directors for expenses, attorney's fees and any liability even if not successful in defending against a claim so long as the directors or a court find that "such person acted in good faith and in a manner he reasonable believed to be or not opposed to the bests interests of the corporation, and with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful."

157 The particular provisions and conditions for corporation reimbursement of expenses are set forth in § 55A-17.2 in actions by outsiders.

158 This is, however, quite uncommon in nonprofit organizations and probably unheard of in the usual pastoral setting.

159 The specifics of these provisions are set forth in § 55A-17.3.