

Protect your board against personal liability

By David Middlebrook and Robert W. Rucker

Without good, talented and faithful management, the church organization cannot succeed. But as the church grows and becomes more akin to a secular business in terms of day-to-day operations, many people worry about their potential personal liability for actions taken as an officer or director of the church.

This article assumes that your church is a nonprofit corporation. If you are operating as an unincorporated association, assumed name, or in some other unincorporated format, it is quite likely that everyone associated with your operation is exposed to being personally liable for the debts and obligations associated with the organization. Incorporation is the fastest and most direct way to create protection against personal liability.

Many jurisdictions do not have specific limitations or qualifications on who can be a director. Sometimes the only requirement is that it be a person over 18 years of age. However, the church must be more discriminating. To limit the prospect for future liability, allow only qualified and experienced individuals to serve as directors. Many churches load up their boards with family members and friends. While such boards may have a level of inherent trust and loyalty to the church or its pastor, they may lack the objectivity and judgment to make hard or unpopular decisions that are ultimately in the church's best interests. The Internal Revenue Service (IRS) is also becoming suspicious of the motivations and judgments of boards that are too heavy with family members and friends. One area that is of particular concern is what is known as "self-dealing" or "insider" activity. This is when a board approves financial transactions that benefit or appear to benefit a particular individual at the expense of the church.

Directors are generally expected to demonstrate a duty of care to the church. Many jurisdictions have laws that say that a director is not personally liable for a debt or obligation of the church if the director exercised ordinary care and acted in "good faith" or in a manner reasonably believed to be in the best interests of the church. This is sometimes called the

"business judgment" rule. A director will not always be knowledgeable in all areas of law, business, accounting or management. Many jurisdictions have laws that say that the director has the right to rely upon information, opinions, reports, and financial statements prepared by or rendered by competent church employees, outside attorneys or accountants, or especially formed committees. Some laws also say that a director is not liable if he or she relied upon applicable religious tenets or laws, or was acting under the direction of a higher religious authority (such as a district supervisor in a hierarchal church organization). The key is that the director has to know that such sources are competent in the area in question. If the director knew that the source giving the information was not reliable, competent or was self-dealing, then the director is expected to use independent judgment. If you're a director and you don't believe you have enough information or do not understand what is being said, don't be afraid to say so.

Most jurisdictions place personal liability on a director for intentional misconduct, gross negligence and criminal actions. While the new provisions of the Sarbanes-Oxley Act do not all apply in the nonprofit world, two areas that do are document destruction and interfering with a whistleblower. Another common area of concern is with child abuse. Many states now have mandatory reporting of suspected child abuse or neglect. Officers or directors who engage in the discredited practice of trying to cover up such complaints could face criminal prosecution.

Directors are expected to show a duty of loyalty to the church. This generally means not allowing any conflicts of interest or self-dealing. Some jurisdictions will excuse a director from personal liability in such transactions if there is a recorded vote showing the director was opposed to and voted against the transaction in question.

As a practical matter, when a church is sued by a third party, we often see the party include one or more officers or directors as named individual parties. This is because:

- The attorney is not sure if he or she should add the officers or directors, but does not want to take a chance on missing a necessary party.
- The attorney believes it to be necessary in the event there is a church insurance policy.
- The attorney hopes that the trauma of being personally named in a lawsuit will motivate the director to pressure the church to settle the claim.
- Naming the individual director may put the director at odds with the church, such as for a church transaction that the director did not agree with, and thus create a tension or conflict between the church and its directors that can be exploited.
- The director is independently wealthy and might be willing to pay something to get released from the case.
- When a director is named personally in a lawsuit, most churches will defend that director along with the church itself.

Some of the ways to prevent or limit directors from being exposed to personal liability include:

- Place only qualified people in that position, preferably of dissimilar personalities or from different backgrounds.
- Ensure that the directors are always observing the duties of care and loyalty discussed above.
- Incorporate the church.
- Give directors access to good information. Use professional assistance when necessary and make sure the information relied upon is retained for future reference.
- Obtain director and officer insurance (sometimes called E & O insurance).
- Create and implement a conflicts of interest and self-dealing policy.
- Create and implement strong

internal controls for accounting and financial transactions.

- Have written indemnification agreements whereby the church agrees to indemnify (pay for) claims made against individual directors based upon actions taken on behalf of the church.

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