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FIDUCIARY DUTIES OF DIRECTORS OF CALIFORNIA NONPROFIT PUBLIC BENEFIT CORPORATIONS AND FOREIGN NONPROFIT CORPORATIONS DOING BUSINESS IN CALIFORNIA

Under California law, the business and affairs of a nonprofit corporation shall be managed, and all corporate powers shall be exercised by or under the direction of the board of directors. Each director has personal, non-delegable fiduciary duties to the corporation. Principally, these duties are the duty of care and the duty of loyalty. This memorandum discusses the manner in which a careful director approaches his duties in serving the nonprofit. The first section summarizes the duty of care, including a discussion of the manner in which a careful director meets the standard of care. The second section discusses the duty of loyalty, with particular emphasis on dealing with actual and potential conflicts of interest. The third section describes the specific standards for corporate governance in the newly enacted California Nonprofit Integrity Act and the Sarbanes Oxley Act of 2002 (15 U.S.C. § 7201 et seq.) In carrying out these duties to the charity, a director will be accountable to and subject to oversight by the Registry of Charitable Trusts of the Office of the Attorney General of California.

The Duty of Care

A director should act (1) in good faith, (2) in a manner he believes to be in the best interests of the corporation, (3) which includes making reasonable inquiry when appropriate, (4) just as an ordinarily prudent person would do in a similar position and under similar circumstances.

In practical terms, this duty compels a director to (1) make himself reasonably informed as to matters which come before the board of directors, (2) actively participate in decisions of the board, including asking questions and proposing further investigation where appropriate, and (3) act honestly, carefully, cautiously and at arm's length in all of his dealings with the corporation and its other directors. The key to being a good board member is not that the director never makes a wrong decision or that the director know every technical detail about a topic that comes before him; instead, the key is that he engage in a decision-making process that is deliberate, thorough and thoughtful in its exploration and identification of relevant issues and alternatives to take on behalf of the corporation.

A director should:

- Attend meetings regularly. Attendance at a board meeting is not a privilege that can be delegated. This means that a director cannot vote by proxy. A director needs to be informed and aware, and the only way to do those things is to attend scheduled meetings which should occur at regular intervals. Directors should be cautious about ratifying or authorizing major corporate activities or transactions by written consent; important board decisions are most thoughtfully approached in person and are accompanied by ample written materials and oral presentations.

- Avoid haste in making decisions, as well as the appearance of haste. A director should make major decisions only after full briefing by appropriate experts on a given topic and only after full opportunity to digest all available material information. Hasty decisions often are made in the context of important events such as a merger. In these situations, the board may confront an accelerated timetable, and here it is important to have as much relevant information as possible, as far in advance of the deadline as possible, because the exposure to liability is greatest in connection with such decisions.

- Prepare. Courts have been particularly critical of directors who do not avail themselves of all material information pertinent to the matter on which they are asked to vote. A director should carefully study all material he is given in advance of the board meeting, so that he is armed with sufficient ammunition to raise appropriate questions and concerns. Information is generally supplied by staff. If a director feels that the information supplied is inadequate in any respect, he should not hesitate to ask the staff to provide additional information within a reasonable period of time.

- Ask questions. A director should probe, test and judge the reliability and accuracy of the information with which he is presented, and then make sure he understands it.

- Take minutes. Each meeting of the board should be recorded by a person in attendance, usually the board's secretary or counsel. Contemporaneously prepared minutes are an important documentation of the issues before the board, the roles of the directors confronting those issues, and an accurate history of the corporation. Individual directors should keep their own notes in their files of each board meeting in case the conduct of any one of them is ever questioned.

- Review the transaction. A director should make sure he has an opportunity to review the final documents proposed to consummate any transaction over which the board exercises authority. A director must understand and approve the material terms of the transaction if he is to vote affirmatively.

- Experts. A director may rely on experts' reports under certain circumstances. An expert may be an officer or employee of the corporation who is believed to be reliable and competent in the matters presented; counsel to the corporation or independent accountants as to matters the director believes to be in their professional competence; or a committee or board member the director believes to merit confidence. A director ought not simply rely on such experts or presenters. He must make reasonable inquiry where the circumstances suggest inquiry is appropriate, and he ought not rely on a so-called expert when a "red flag" would suggest to a reasonably prudent person that the report is not entitled to great weight. In all of these decisions, a director should act in good faith in choosing to rely on a particular report.

- <u>Delegation</u>. A director may not delegate management and oversight responsibilities, but the board as a whole may delegate the day-to-day functions of the corporation to others. A director will not be held responsible for actions or omissions of officers, employees or agents of the corporation as long as such persons are prudently selected, reasonably monitored and relied upon reasonably. It is unfortunately all too common for directors of nonprofit corporations to become so involved in the day-to-day affairs of the corporation as to clash with management and staff. Therefore, the board may wish to consider making a formal delegation of authority to its chief executive officer.

- <u>Resolutions or policies</u>. Board resolutions or committee recommendations intended to be adopted as the corporation's policies and procedures must be approved by the board at each meeting, or by unanimous written consent of the Board. Actions taken at a meeting must be summarized in minutes filed in the corporation's record book. Any resolution adopted by unanimous written consent must also be kept in the corporate record book. Legal counsel can assist with drafting appropriate resolutions to effect board decisions.

A director discharging the duty of care is also responsible for <u>overseeing</u> the management activities of the corporation. This responsibility includes the following board actions:

- Assuring the existence of adequate corporate information gathering and dissemination or reporting systems. Only in this way can a director sufficiently monitor the direction of the corporation and whether it is being managed to meet its long-term charitable and economic objectives.

- Approving fundamental operating, financial and other corporate plans, strategies and objectives.

- Evaluating the performance of the corporation and its management, especially the CEO.

- Selecting, evaluating and approving the compensation package for senior executives.

- Adopting policies of corporate conduct and accounting, financial and other controls. A director may be held responsible for ignoring "red flags" or obvious danger signs of wrongdoing by an officer or an employee. A director may also be liable for having selected or allowed to continue in employment an officer or employee who is demonstrated to be untrustworthy or malfeasant.

The Duty of Loyalty

A loyal director acts exclusively to promote the best interests of the corporation and not for his own interest or the interest of any other person or entity, even the particular interest of the constituency that selected him for the position. The issues arising out of a director's duty of loyalty involve (A) conflicts of interest, (B) corporate opportunity, and (C) confidentiality.

A. Conflicts of Interest. A conflict of interest arises when a director has a material personal interest (whether or not financial) in a proposed contract, transaction or activity in which the corporation is involved. The conflict may be direct (e.g., the director proposes to provide professional services for a fee) or indirect (e.g, the director may have an employment or investment relationship with the other party to the transaction or may have provided services to the other party).

Undisclosed conflicts, while not always fatal to the transaction or to the interested director, expose the interested director and the entire board to substantial risks of personal liability and tax penalties. A wise director always discloses potential conflicts of interest. Disclosure of the conflict accomplishes two things: First, it enables other directors to evaluate the transaction for fairness. Second, it enables the other directors to determine whether the public image of the corporation could be adversely affected by proceeding with a transaction which has the appearance of impropriety.

In order to limit any inadvertent conflict of interest transactions, the Board of Directors should adopt a conflict of interest policy. The policy should be drafted to require that each person who is in a position to exercise influence over the organization must disclose all entities controlled by him, and must recuse himself from discussions of transactions to which he and such controlled entities are parties. The Board should always consult with counsel before entering into any transaction with any disqualified person or entity in which a disqualified person has a financial interest, including, but not limited to, the execution of employment contracts, leases, and sales or exchanges of property.

B. Corporate Opportunity. Before a director participates, either personally or professionally, in a transaction with a third party that the director knows may now or in the future be of interest to the corporation, the director should affirmatively present the opportunity to the board before participating in the transaction outside the corporation.

C. Confidentiality. As a matter of good business sense, a director should not make public disclosures about the corporation's private business activities, unless they are already known by the public or are part of a public record. An individual director is not authorized to be a spokesperson for the corporation and should avoid responding to inquiries, particularly about financial information. Instead, a director should refer such inquiries to the CEO or other designated recipient. In this way, a director may avoid inadvertently making remarks that could damage a corporation's public image, impede an important transaction, or otherwise adversely affect the corporation. Some public benefit corporations face the unique situation of confronting an individual or group that demands that meetings of the board be open to the public; mixed public-private activities of the corporation may subject the corporation to such a requirement. The directors should contact counsel if open meetings are desirable or if mixed public-private activities will arise. In these instances, specific rules as to confidentiality will have to be developed.

New Standards of Conduct for California Nonprofits

California recently adopted the Nonprofit Integrity Act of 2004, which took effect on January 1, 2005. In addition, some provisions of Sarbanes-Oxley are relevant to the conduct of nonprofit Boards: the provisions of Section 1107 that punish retaliation against whistleblowers, and the penalties in Section 1102 that apply to improper document destruction.

The Nonprofit Integrity Act. The Nonprofit Integrity Act has three major themes that directors must understand. First, the Act imposes some new rules regarding audit and accounting oversight. Second, the Act includes new rules for professional fundraisers and fundraising counsel. Third, the Act includes an entirely new section of the Government Code that proscribes a host of behaviors by nonprofits that will subject the nonprofit, and its managers, to significant penalties. Of particular interest to the governing body is the new requirement that, if the nonprofit has more than $2 million in gross revenue in a year, the board must obtain an independent audit of the organization and ensure that a properly constituted audit committee is in place.

Whistleblower Retaliation. California law has included provisions punishing employers for retaliation against whistleblowers for some time. In addition, Section 1107 of Sarbanes-Oxley now includes a federal criminal penalty to punish retaliation against an employee who provides to a law enforcement officer truthful information relating to the commission or possible commission of any Federal offense (which would include tax fraud) is punishable by fine and/or imprisonment up to 10 years.

Accordingly, in addition to preventing or eliminating careless or improper accounting practices through audits and written policies, a California nonprofit should develop procedures for handling employee complaints. A nonprofit should encourage use of the process by enabling confidential and anonymous mechanisms by which employees can bring perceived abuses to the attention of the governing board or legal counsel. A nonprofit should also develop a formal process to deal with any such reports. The process must take employee complaints seriously and document any investigation and the action taken, including any remedial action taken, or the justification for non-action.

Document Destruction. Section 1102 of Sarbanes-Oxley addresses document destruction. Under this law, it is a criminal offense to "corruptly" alter, destroy, mutilate or conceal a record to prevent its use in any official federal proceeding, including a federal tax audit. Such an act is punishable by fine and/or imprisonment of up to 20 years.

Obviously, document destruction is a necessary process for any organization, whether for-profit or not-for-profit. With the new penalties for improper destruction, it is more important than ever that a nonprofit corporation have in place a monitored document retention and destruction policy. The policy should address not only the proper handling of paper documents, but also electronic documents and voice mail. The policy should also include systems for backing up and checking the reliability of the document retention system. Finally, the policy must include procedures for protecting documents in any way relevant to any official investigation that is underway or suspected.

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Church Law&TaxReport

A REVIEW OF LEGAL AND TAX DEVELOPMENTS AFFECTING MINISTERS AND CHURCHES SINCE 1987

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Could You Be Sued for Mismanaging Your Church's Money?

The personal liability of church officers, directors, and trustees

Traditionally, the officers and directors of nonprofit corporations performed their duties with little if any risk of personal legal liability. In recent years, a number of lawsuits have attempted to impose personal liability on such officers and directors. In some cases, directors are sued because of statutes that provide limited legal immunity to churches. (I discuss this topic at length in section 6-08 of Pastor, Church & Law, Vol. 2: Church Property & Administration.)

As a general rule, directors are not responsible for actions taken by the board prior to their election to the board (unless they vote to ratify a previous action). Similarly, directors ordinarily are not liable for actions taken by the board after their resignation. Again, they will continue to be liable for actions that they took prior to their resignation.

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ONE-MINUTE SUMMARY

A QUICK REVIEW OF THE MOST IMPORTANT INFORMATION IN THIS ISSUE.

- Traditionally, the officers and directors of nonprofit corporations performed their duties with little if any risk of personal legal liability. In recent years, a number of lawsuits have attempted to impose personal liability on such officers and directors. In some cases, directors are sued because of statutes that provide limited legal immunity to churches. *page 1*

- A charity permitted an outside group to use its facility for a Christmas party. During the party, a woman suffered serious injuries when she fell on a slippery floor. As a result of her injuries the woman underwent surgery for a complete hip replacement. She later sued the charity, claiming that it was responsible for her injuries because it had retained control over the premises during the party. She claimed that the floor was unreasonably slippery, and this dangerous condition caused her to fall. One witness testified, "It was obvious that floor was slippery. It was just waxed or something. I mean it wasn't dirty. It was clean. Probably too clean." *page 8*

- Does a church have the legal authority to remove disruptive individuals from church services? This issue has been addressed by a number of courts. Generally, the courts have been sympathetic to attempts by churches to deny access to disruptive individuals. *page 9*

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[Senior Editor Richard R. Hammar, JD., LL.M., CPA. Published by Christianity Today International.]

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A number of state laws permit nonprofit corporations to amend their bylaws to indemnify directors for any costs incurred in connection with the defense of any lawsuit arising out of their status as directors. While there are several theories of liability related to officers, directors, and trustees, in this article, we'll focus on breach of fiduciary duty of care.

Breach of the Fiduciary Duty of Care

KEY POINT. Church board members have a fiduciary duty to use reasonable care in the discharge of their duties, and they may be personally liable for damages resulting from their failure to do so.

1. In General

The board members of business corporations are under a duty to perform their duties "in good faith, in a manner they reasonably believe to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances." This duty commonly is referred to as the "prudent person rule" or the "duty of due care." In recent years, some courts have extended this duty to the board members of nonprofit corporations.

What Jim Bakker Taught Us

A ruling of the bankruptcy court in the PTL ministry bankruptcy case addressed the liability of directors and officers. *Heritage Village Church and Missionary Fellowship, Inc., 92 B.R. 1000 (D.S.C. 1988).*

The court agreed with the bankruptcy trustee that televangelist Jim Bakker (as both an officer and director) had breached his legal duty of care to PTL. It quoted a South Carolina statute (PTL was located in South Carolina) that specifies the duty of care that a director or officer owes to his or her corporation:

A director or officer shall perform his duties as a director or officer, including his duties as a member of any committee of the board of directors upon which he may serve, in good faith, in the manner he reasonably believes to be in the best interest of the corporation and of its shareholders, and with such care as an ordinary prudent person in a like position would use under similar circumstances. *Quoting S.C. Stats. Ann. § 33 13 150(a).*

The court, in commenting upon this provision, observed:

Good faith requires the undivided loyalty of a corporate director or officer to the corporation and such a duty of loyalty prohibits the director or an officer, as a fiduciary, from using this position of trust for his own personal gain to the detriment of the corporation. In this instance, there are no shareholders of the corporation; however, even though there are no shareholders, the officers and directors still hold a fiduciary obligation to manage the corporation in its best interest and not to the detriment of the corporation itself.

The court concluded that "the duty of care and loyalty required by [Bakker] was breached inasmuch as he (1) failed to inform the members of the board of the true financial position of the corporation and to act accordingly; (2) failed to supervise other officers and directors; (3) failed to prevent the depletion of corporate assets; and (4) violated the prohibition against self-dealing."

With respect to Bakker's defense that his actions had been "approved" by the board, the court observed that Bakker "exercised a great deal of control over his board" and that "a director who exercises a controlling influence over co-directors cannot defend acts committed by him on the grounds that his actions were approved by the board." The court acknowledged that officers and directors cannot be "held accountable for mere mistakes in judgment." However, it found that "the acts of [Bakker] did not constitute mere mistakes in judgment, but constituted gross mismanagement and a neglect of the affairs of the corporation. Clearly the salaries, the awards of bonuses and the carte blanche exercised over PTL checking accounts and credit cards were excessive and without justification and there was lack of proper care, attention and circumspection to the affairs of the corporation. [Bakker] breached [his] duty to manage and supervise . . . ."

In support of its conclusions, the court cited numerous findings, including the following: (a) Bakker failed to require firm bids on construction projects though this caused PTL substantial losses; (b) capital expenditures often greatly exceeded estimates, though Bakker was warned of the problem; (c) Bakker rejected warnings from financial officers about the dangers of debt financing; (d) many of the bonuses granted to Bakker were granted "during periods of extreme financial hardship for PTL"; (e) Bakker "let it be known that he did not want to hear any bad news, so people were reluctant to give him bad financial information"; (f) "it was a common practice for PTL to write checks for more money than it showed in its checkbook; the books would often show a negative balance, but the money would eventually be transferred or raised to cover the checks written–this 'float' often would be three to four million dollars"; (g) most of the events and programs at PTL that were made available to the public were operated at a loss; since 1984, "energy was placed into raising lifetime partner funds rather than raising general contributions"; (h) Bakker "during the entire period in question, failed to give attention to financial matters and the problems of raising money and cutting expense."

Though at the time of Bakker's resignation in 1987 PTL had outstanding liens of $35 million, and general contributions were in a state of decline, "millions of dollars were being siphoned off by excessive spending." Such spending, noted the court, "is shocking to the conscience to

Discharging the Fiduciary Duty of Due Care

Lawsuits against nonprofit directors for breach of their "duty of care" are still rare. There are a number of ways that church board members can reduce the risk of liability for breaching the fiduciary duty of due care including the following:

- attending all of the meetings of the board and of any committees on which they serve
- thoroughly reviewing all interim and annual financial statements and reports, and seeking clarification of any irregularities or inconsistencies
- affirmatively investigating and rectifying any other problems or improprieties
- thoroughly reviewing the corporate charter, constitution, and bylaws
- dissenting from any board action with which they have any misgivings, and insisting that their objection be recorded in the minutes of the meeting
- resigning from the board if and when they are unable to fulfill these duties

As one court has observed, "the law has no place for dummy directors."

the extent that it is unbelievable that a religious ministry would be operated in such a manner." The court concluded that "Mr. Bakker, as an officer and director of PTL... approached the management of the corporation with reckless indifference to the financial consequences of [his] acts. While on the one hand [he was] experiencing inordinate personal gain from the revenues of PTL, on the other hand [he was] intentionally ignoring the extreme financial difficulties of PTL and, ironically, [was], in fact, adding to them." To illustrate, Bakker accepted huge bonuses at times of serious financial crisis at PTL. "Such conduct," noted the court, "demonstrates a total lack of fiduciary responsibility to PTL."

The court emphasized that *"trustees and corporate directors for not-for-profit organizations are liable for losses occasioned by their negligent mismanagement."*

2. Investing Church Funds

Those who serve on a board of directors, whether for a church or any other organization, have a legal duty to perform their duties in good faith, in a manner they reasonably believe to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. This duty commonly is referred to as the "prudent person rule" or the "duty of due care."

The fiduciary duty of due care often is set forth in a state's nonprofit corporation law. To illustrate, the Revised Model Nonprofit Corporation Act, which has been enacted in a small but growing number of states, contains the following language:

> A director shall discharge his or her duties as a director . . . (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.
>
> In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by: (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented; (2) legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence . . . . *Revised Model Nonprofit Corporation Act § 8.30.*

This duty of due care applies to the investment of corporate funds. However, directors are not accountable for every bad investment they authorize. They are not held to a standard of perfection. Rather, they are accountable only if an investment decision was not based on "the care an ordinarily prudent person in a like position would exercise under similar circumstances." The courts have been reluctant to impose liability on directors for an exercise of poor judgment. One state Supreme Court, in language that has been quoted by several other courts, observed:

> [There is] a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

What steps can church officers and directors take to reduce the risk of violating the fiduciary duty of due care? Consider the following:

- **Check state law.** If your church is incorporated under state law, be sure to check your state nonprofit corporation law for any provisions that address the duties of officers and directors. This information should be made available to all of the church's officers and directors.

- **Check the church's governing documents and minutes.** The governing documents (i.e., articles of incorporation or bylaws) of some churches contain restrictions on investments. Such restrictions may also appear in the minutes of congregational or board meetings. It is essential for board members to be familiar with these restrictions and to enforce them.

- **Use an investment committee.** Many nonprofit organizations use an investment committee to make recommendations regarding the investment of funds. This can be an excellent way to reduce the liability of board members for poor investment decisions. Rather than make decisions themselves, the board appoints an investment committee that includes individuals with proven investment or financial expertise. Committee members may include stock brokers, CPAs, attorneys, bankers, financial planners, and business leaders. Of course, the committee's recommendations ordinarily must be approved by the governing board, but by relying on the advice of experts the board is greatly reducing the risk of being liable for poor investment decisions. After all, they were relying on the advice of experts.

KEY POINT. The Model Revised Nonprofit Corporation Act (quoted above) specifies that "in discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by . . . persons as to matters the director reasonably believes are within the person's professional or expert competence . . . ." This language provides directors with considerable protection when relying on the advice of experts on an investment committee.

- **Investment policy.** A church congregation or board can create an investment policy to govern investment decisions. A policy can prohibit investments in specified instruments or programs.

- **Avoid speculative or risky investments.** If a proposal sounds "too good to be true," it probably is. Any scheme that promises to "double your money" in a short period of time should be viewed with extreme skepticism. It is absolutely essential that such schemes not be pursued without the thorough evaluation and recommendation of persons with financial and investment expertise.

KEY POINT. Do not rely on the "expert opinion" of persons representing the promoter of an investment scheme. Investment schemes must be reviewed by independent and objective persons having financial and investment expertise. Ideally, these persons will be members of your

Ponzis, Pyramids, and Other Investment Scams

The United States Securities and Exchange Commission (SEC) lists four common investment scams that are perpetrated on religious organizations--pyramid schemes, Ponzi schemes, Nigerian investment scams, and prime bank scams. The SEC has provided the following warning signs of fraudulent bank-related investment schemes:

Excessive guaranteed returns. These schemes typically offer or guarantee spectacular returns of 20 to 200 percent monthly, absolutely risk free! Promises of unrealistic returns at no risk "are hallmarks of prime bank fraud."

Fictitious financial instrument. Despite having credible-sounding names, the supposed "financial instruments" at the heart of any prime bank scheme simply do not exist. Exercise caution if you've been asked to invest in a debt obligation of the "top 100 world banks," Medium Term Bank Notes or Debentures, Standby Letters of Credit, Bank Guarantees, an offshore trading program, a roll program, bank-issued debentures, a high yield investment program, or some variation on these descriptions. Promoters frequently claim that the offered financial instrument is issued, traded, guaranteed, or endorsed by the World Bank or an international central bank.

Extreme secrecy. Promoters claim that transactions must be kept strictly confidential by all parties, making client references unavailable. They may characterize the transactions as the best-kept secret in the banking industry, and assert that, if asked, bank and regulatory officials would deny knowledge of such instruments. Investors may be asked to sign nondisclosure agreements.

Exclusive opportunity. Promoters frequently claim that investment opportunities of this type are by invitation only, available to only a handful of special customers, and historically reserved for the wealthy elite.

Claims of inordinate complexity. Investment pitches frequently are vague about who is involved in the transaction or where the money is going. Promoters may try to explain away this lack of specificity by stating that the financial instruments are too technical or complex for "non-experts" to understand.

You should be especially watchful for prime-bank related schemes promoted over the Internet.

It is also best to avoid investing all or a significant portion of available funds in the stock of one company, since the lack of "diversification" creates added risk. Investing in stock generally should be avoided unless investments are sufficiently diversified (for example, through conservative mutual funds) and recommended by a knowledgeable investment committee.

church, or persons within your community who have a reputation of unquestioned integrity.

KEY POINT. Remember, you are investing donated funds. This is no time to be taking risks. Not only do officers and directors have a legal duty to exercise due care in the investment of church funds. Just as importantly, they have a moral duty to be prudent in their investment decisions. No officer or director wants to explain to church members at an annual business meeting how some of their contributions were lost due to poor investments.

• **Avoid investing in companies or programs in which a board member has a personal interest.** The third case summarized above demonstrates the need to avoid investing in companies or programs with direct ties to a member of your board. Such investments are not always inappropriate. But they demand a higher degree of scrutiny.

KEY POINT. A church's investments should be reviewed at every board meeting. This ensures that all investments will be continuously monitored, and that necessary adjustments can be made.

• **Trustees have a higher duty.** Sometimes church board members are designated as the trustees of a charitable trust. For example, a member dies leaving a large sum to the church for a specific purpose and designates the church board as the trustee of the fund. Trustees are held to an even higher degree of care in the investment of trust funds than officers or directors of a corporation. However, the Revised Model Nonprofit Corporation Act specifies that "a director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property." In other words, a church officer or director is not automatically deemed to be a "trustee" of church funds. Officers and directors generally are held to the higher legal standard applicable to trustees only if they are designated as trustees in a legal instrument that creates a trust fund.

• **Conclusion.** Church officers and directors must take steps to inform themselves about any investment decision involving church funds. They can rely on a number of safeguards, including their own research, the recommendations of an investment committee, and common sense.

Example. A federal court in Indiana ruled that the directors of a church subsidiary could be sued individually for financial losses incurred by investors in a securities scam on the basis of their breach of their fiduciary duty of care. *Marwil v. Grubbs, 2004 WL 2278751 (S.D. Ind. 2004).*

Example. A Minnesota court ruled that a church officer violated his fiduciary duties to his church as a result of his secret efforts to remove the pastor and have the church property transferred to a new church that he had formed. The court noted that "an officer of a nonprofit corporation owes a fiduciary duty to that corporation to act in good faith, with honesty in fact, with loyalty, in the best interests of the corporation, and with the care of an ordinary, prudent person under similar circumstances." The officer conceded that he owed a fiduciary duty to the church, but he insisted that the

evidence did not support a finding that he breached his fiduciary duty because his actions were consistent with the wishes of the church members who supported him. The court disagreed: "As the bearer of a fiduciary duty, the law imposed on him the highest standard of integrity in his dealings with the other officers of [the church] and the entire [church] congregation, not just those who [supported him]. Therefore . . . as an officer of [the church] his fiduciary duty prevented him from assuming positions, and taking actions, that conflicted with the interests of [the church] and the congregation as a whole. . . . There is sufficient evidence in the record to establish that the officer breached his fiduciary duty to [the church]. He admitted that while he was vice president of the church he organized a faction for the purpose of forming another church to directly compete with [the original church]. Further, the formation of a new church was intended to be a method of circumventing the national church's termination provisions governing the pastor's services. To achieve his goals, he held secret meetings and continuously encouraged secrecy among [his supporters]. He did not inform other church officials and members of . . . his plans to form [a new church], separate from [the original church], and transfer the church property from [the original church to the new church] without compensation." *Shepherd of the Valley Lutheran Church v. Hope Lutheran Church, 626 N.W.2d 436 (Minn. App. 2001).*

Example. A Minnesota court dismissed a lawsuit brought by Lutheran pastors against a denominational pension board for allegedly breaching their fiduciary duty to participants by not investing in companies that did business in South Africa. The Evangelical Lutheran Church in America (ELCA) established a board of pensions in 1988 to manage and operate a pension fund for Lutheran pastors and lay employees "exclusively for the benefit of and to assist in carrying out the purposes of the ELCA." The ELCA adopted the position that the system of apartheid in South Africa was so contrary to Lutheran theology that it had to be rejected as a matter of faith. The ELCA passed a resolution to "see that none of our ELCA pension funds will be invested in companies doing business in South Africa." A dissenting group of Lutherans opposed the ELCA's decision to use its assets as a political weapon and asked to withdraw their pension funds. When their request was denied they sued the board of pensions and the ELCA, claiming that both groups had violated their fiduciary duties to participants in the pension program by elevating social concerns over sound investment strategy. A state appeals court dismissed the lawsuit on the ground that a resolution of the lawsuit would require the court to interpret religious doctrine in violation of the First Amendment's nonestablishment of religion clause. The court concluded that the "ELCA enacted the [apartheid] policy in an effort to further its social and doctrinal goals . . . . Accordingly, any review of the Board of Pensions' [investment policy] would entangle the court in reviewing church doctrine and policy." *Basich v. Board of Pensions, 540 N.W.2d 82 (Minn. App. 1995).*

Example. A New York court ruled that the officers of a nonprofit organization violated their fiduciary duties and could be removed from office by the attorney general and ordered to pay damages. The state attorney general of New York sued the officers of a charity seeking to hold them personally liable and financially accountable for amounts totaling more than $120,000 which they allegedly received in violation of their fiduciary duties. The attorney general also sought to remove two of the officers and permanently bar them from ever serving as board members of a public charity. One of the officers freely admitted that he charged several personal expenses to the charity, but defended himself by stating, "I erroneously believed that it would be permissible for me to charge certain personal expenses to [the charity] and have them reclassified as personal expenses to be paid back to [the charity]." The court called this allegation "startling," and further observed, "This court is at a loss as to why anyone would think they could charge something to a not-for-profit corporation as long as they paid it back later. After all, [the charity] is a not-for-profit corporation and not a revolving credit line." *Spitzer v. Lev, 2003 WL 21649444 (N.Y. Sup. 2003).*

Example. A New York appeals court ruled that directors of a charitable trust could be sued for breaching their fiduciary duties. A child of the founder of the trust filed a lawsuit seeking to remove 8 of the trust's 11 directors. He asserted that the 8 directors breached their fiduciary duties, mismanaged the trust's investments, and negligently selected the trust's investment advisor. The court ruled that the 8 directors could be sued. It noted that "it is well established that, as fiduciaries, board members bear a duty of loyalty to the corporation and may not profit improperly at the expense of their corporation." In this case, the lawsuit alleged that the 8 directors breached their fiduciary duties by investing a substantial portion of the trust's assets in speculative securities and in the stock of a company with direct ties to the directors. The court concluded that the "business judgment rule" (which protects directors from any liability for their reasonable and good faith decisions) did not apply in this case, since it was not available "when the good faith or oppressive conduct of the officers and directors is in issue." *Scheuer Family Foundation, Inc. v. 61 Associates, 582 N.Y.S.2d 662 (A.D. 1 Dept. 1992).*

Example. An Ohio court refused to allow church members to sue board members personally for breaching their fiduciary duties by failing to oust a pastor who allegedly had engaged in financial improprieties. It observed: "Inquiry into the relationship between the trustees and the congregation in matters concerning the pastorship would require the courts to consider each party's view of who should preach from the pulpit. Review of such matters would further require the court to determine the issue of whether the trustees' performance of their duties met the standards of the congregation and would therefore involve an inquiry into ecclesiastical concerns. Therefore . . . civil courts lack . . . jurisdiction to entertain such matters. . . . [We] hold that the lower court has no jurisdiction over the claims brought by the individual members of the congregation seeking to . . . hold the board liable for breach of fiduciary duty to the congregation." *State v. Meagher, 1997 WL 180266 (Ohio App. 1997).*