Conflicts of interest: How to avoid them, how to deal with them - Part 1

<< BACK

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Legal and financial implications

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Board members have the primary legal and moral responsibility for the governance of the church and for seeing that its mission is carried out. To accomplish its mission, the board must maintain the confidence of its members and the public at large. However, confidence in the church can be shaken when the board is involved in a transaction in which a real or perceived conflict of interest exists. Improper handling of these transactions may result in legal action, the awarding of damages or other sanctions. Furthermore, failure to recognize and properly handle these situations can impose personal liability on board members. Consequently, it is vital that board members closely examine whether they have a conflicting interest in a particular transaction.

The most common sources of conflicts are transactions that involve awarding contracts to family members to perform services for the church, such as installations (HVAC systems, audiovisual systems, etc.), landscaping and building maintenance. Other transactions that can create conflicts include the sale or purchase of church property to family members or the employment of a family member. Thus, it is important that board members understand their legal duties and responsibilities, primarily the duty of care and loyalty.

Legal duties and responsibilities

The duty of care means that a board member must participate in the decisions of the board and have access to information relevant to such decisions. Under the nonprofit laws of most states, to meet the duty of care, a board member should discharge his or her duties in "good faith," meaning in a manner the board member reasonably believes to be in the best interest of the church and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. This is often called the prudent person rule.

The duty of loyalty means the board member must make decisions with the church's interest in mind, not for their own personal gain or that of a relative. In other words, a board member may never put their own biases and personal interests above the church, nor may they use their position for personal gain or advantage. If a board member has an interest that is in conflict with the interest of the church, the board member must be conscious of the potential for such conflict and act with candor and care in dealing with such situations. Conflicts of interest involving a board member are not inherently illegal, but it is the manner in which the board member and the board deal with a potential conflict that determines whether the transaction is proper. Following are ways to properly handle a conflicting situation:

1. The board member should be sensitive to any interest they may have in the transaction and, as far as possible, recognize such interest prior to discussion or presentation of such matter to the board.
2. The board member should then disclose to the board voting on the transaction the existence and nature of their conflicting interest prior to their vote on the transaction.
3. Upon disclosure by the board member, the board should provide a disinterested review of the matter.
4. The deliberations of the board should be documented in the meeting minutes and should detail who agreed and who did not and how disagreements were handled. Ordinarily, the board member should abstain from voting on the transaction, and the transaction should be fair and reasonable to the church.

Implement fair compensation

Conflicts of interests involving the hiring of family members can create other problems for the board member and the benefited individual. For many years the Internal Revenue Service has acted as a service organization for nonprofit organizations, rather than a law enforcer. However, the IRS has recently become concerned that salaries and benefits for some employees appear excessive. Churches, like all tax-exempt organizations, are prohibited from engaging in activities that result in inurement of the church's income or assets to private individuals other than as reasonable compensation for services rendered. To avoid legal problems or the appearance of any wrongdoing, churches should follow these guidelines regarding compensation issues:

1. The board or authorized committee should make its decision using appropriate and comparable data showing what other employees in the same field earn. Salary and benefits information is available from a wide variety of sources.
2. The board or authorized committee should be composed entirely of individuals who are not related and do not have conflicts of interest.
3. The board or authorized committee should approve compensation in advance, not retroactively.
4. The deliberations of the board or authorized committee and the terms of compensation should be adequately documented.

It is important that board members understand that the prohibition against inurement is absolute; therefore, any amount is potentially grounds for loss of tax-exempt status. However, the IRS has been reluctant to revoke the tax-exempt status of churches and other nonprofit organizations. Rather, the IRS may impose an intermediate sanction in the form of an excise tax on the individual that benefited from the improper transaction, as well as on board members who participated in the transaction. The individual who benefits from an excess benefit transaction is also required to return the excess benefits to the church.

Nowadays, churches and their leaders often find themselves in situations where they could end up facing a lawsuit. Board members should fully understand their legal responsibilities and treat all transactions with a real or perceived conflict appropriately. CE

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