

Legal Advice (Board and Officers Liability)

[<< BACK](#)

From Volume 2005, Issue 7 - 7 2005

One of the main reasons to incorporate is to provide all church officers, directors and employees protection from personal liability for church debts or liabilities. However, sometimes persons suing the church corporation will also include the individual o

by: David Middlebrook and Robert W. Rucker

One of the recurring recommendations we make to church clients is to not operate as an unincorporated association. Many state and federal tax exemption forms essentially assume the church to be incorporated. One of the main reasons to incorporate is to provide all church officers, directors and employees protection from personal liability for church debts or liabilities. The corporate filing makes the church corporation responsible for such things, not the individuals managing or administering the church. However, sometimes, persons suing the church corporation will also include the individual officers, directors and employees of the church as named parties and seek to impose personal liability upon them. An effort to impose that personal liability is often called "piercing the corporate veil," that is, asking the court to ignore the corporation status of the church.

Areas of concern

There are typically two common areas where this sort of attempt is made. One is where the church is alleged to be run by one or more individuals in such a way that the corporate filing is being totally ignored and that the church is in actuality controlled by this small group and not by the church corporation's board of directors. Another common area is where the church has subsidiary organizations which are alleged to be too controlled by the parent corporation or by certain individuals such that there is no real difference between them.

Each jurisdiction has different rules or guidelines as to what must be shown in order to pierce the corporate veil, but as a general proposition a person seeking to ignore the corporate filing will need to prove the following: (1) that corporate formalities are not being observed, (2) that the corporation is merely a vehicle for the personal interest of the control person, (3) that the corporation lacks equity capital so as to be a mere shell, and (4) that the corporation's affairs are dominated by one person or another entity by virtue of ownership, control and congruency of established goals.

Examples of not following corporate formalities might include not having regularly scheduled board meetings or not following written by-law procedures. Showing that the corporation is merely a vehicle for the personal interest of the person in control is usually attempted by proving that inordinate compensation has been paid to that person. Inordinate compensation might be money or other benefits that are above and beyond what a church of a similar size or demographic would normally pay, or money that the church cannot really afford. As to subsidiaries of the church, the questions usually relate to (1) whether the subsidiary is adequately funded to carry out its stated task, (2) whether it relies upon the parent for all or most of its financial support, (3) whether it follows corporate formalities, and (4) whether it is managed by its own personnel or simply an extension or puppet of the parent.

Show proof of improper conduct or fraud

Most jurisdictions also require some further proof showing that either the corporate shell was being used for some improper conduct or purpose or to perpetuate a fraud. In other words, there needs to be some purposeful or known intention to misuse the corporate structure to deceive others. It must be shown that the corporation is not only influenced and governed by the control person or parent, but that there is such a unity of interest and ownership that the individuality or separateness between the two has ceased, and allowing the fiction of the separate existence to continue would sanction a fraud or promote injustice. Some creditors attempt to seek a court finding that the corporate protection should be disregarded because the corporation does not have sufficient assets to satisfy a judgment whereas the officers and directors do. Fortunately, the ability of a creditor to actually recover money is never a reason to disregard the corporate structure.

Some factors that have been considered in deciding if the corporation and its control party or parent should be treated as one and the same include:

- Commingling of funds or other assets between the two.
- The holding out by one party that it is liable for the debts of the other (either by direct statement, or more commonly, by circumstances such as a pattern of the corporation making payments for the personal benefit of the control person).
- Identical equitable ownership.
- Use of the same offices or employees, and mixing the business decisions or affairs between the two.

Of course, the facts and circumstances of each situation will have to be examined to determine if there is sufficient evidence to support disregarding the corporate structure.

Follow corporate guidelines

There is also some debate in the courts as to whether or not the idea of piercing the corporate veil should even have application in the nonprofit sector. After all, nonprofit assets are considered not to be the property of any one individual as a matter of law, but are essentially held in trust for the use and benefit of the nonprofit organization. If there is an abuse of the church's property or assets, the remedy should be the intermediate sanctions penalties under the Internal Revenue Code, that is, substantial taxes and penalties to the person receiving the benefit and possibly revocation of the tax exempt status of the church, if warranted.

In our view, giving what should be nonprofit assets to a third-party creditor based upon a finding that the corporate shell should be disregarded, only compounds the violation of nonprofit law. However, the present general view allows these "piercing of the corporate veil" inquiries. Piercing the corporate veil is often threatened but infrequently applied by the courts. However, the cost of defending against such a claim can rob the church of valuable resources. If you are one of the officers or directors or employees of the church accused of operating the church for your personal benefit, the anxiety of having such a claim resolved, often by a protracted lawsuit, can cause many a sleepless night. You and the church do not ever want to face the prospect of having such a claim made against you. As such, it is always prudent to follow general corporate management guidelines in the operation of the church, such as:

- Make sure the church corporation's articles of incorporation and by-laws are in good order and up to date.
- Make sure the church is actually run in the way described in the articles and by-laws.
- Follow good internal controls for money management.
- Do not let the church participate in financial transactions that are not in its best interests or are not consistent with its religious or charitable purposes.
- Adopt a conflict of interests policy so that no officer or director or the church is personally engaged in any financial transactions of the church or has conflicting interests.
- Make sure the larger compensation packages for church officers or employees are supportable under the church's budget.
- Make use of an independent compensation committee.
- Always sign contracts or other important documents on behalf of the church, disclosing your representational capacity or title.
- While interlocking boards of directors between the church and its subsidiaries are common, make sure there is room for independent thought and action between the two.

David Middlebrook is a shareholder with the law firm Brewer, Anthony, Middlebrook, Burley & Dunn, P.C. in Irving, TX, and leads the nonprofit law group. Robert W. Rucker is a lawyer with Brewer, Anthony, Middlebrook, Burley & Dunn, P.C. They can be reached at (972) 870-9898, or e-mail Rucker at rrucker@brewerlawgroup.com.