Governance Issues For Non-Profit Religious Organizations

Jill S. Manny
INTRODUCTION

In July 1997, a Texas jury awarded $119 million in damages to ten former altar boys and the family of another after finding that the Catholic Diocese of Dallas ignored evidence that a priest was sexually abusing the boys and thereafter attempted to cover up the scandal.1 The terms of the unprecedented judgment mandated that not only the priest but also the diocese satisfy the damage award.2

This article's purpose is not to analyze the verdict's fairness. Rather, it will attempt to shed light on the possible ramifications of the verdict's holding, and to explore miscellaneous rules that may impact the risk borne by dioceses. Regardless of personal and religious sentiment engendered by the case, it seems clear that the potential for future verdicts of the sort awarded in Dallas could seriously jeopardize the financial stability of the dioceses around the country. In light of the established precedence, dioceses must protect themselves from this sort of verdict, both by the anticipation of similar litigation and by effective risk planning. The most popular and perhaps the best way to effectively reduce risk is to separately incorporate the parishes, the dioceses, and the various organizations that support the parishes and dioceses, such as fund-raising entities.

---

1 See Doe v. Hicks, No. 93-05258-G (Texas Dist., Dallas County., 1993).
If properly structured, the incorporation of each organization will limit the liability of the individual parishes and diocese by reducing their exposure to the actions and negligence of parish employees, volunteers, and associated parties.

The corporations formed to protect church assets ordinarily are non-profit corporations formed under state not-for-profit or non-profit corporation laws. These corporations generally qualify as tax-exempt religious and charitable organizations under federal and state laws of income taxation. But these corporations are only effective in limiting liability if the corporations are respected as separate and distinct non-profit corporations. In circumstances where a court disregards the corporate identity of an entity, the principals may be held liable for corporate acts and the assets of related corporations may be at risk to satisfy debts of other corporations. If the corporate veil is pierced, the corporate structure is useless.

The article discusses the proper maintenance of these corporations necessary to ensure that they serve their intended purposes of limiting liability and protecting church assets. The discussion highlights the importance of maintaining both tax-exempt and non-profit corporate status and in addition identifies the types of operations needed to protect both the organization's tax and non-profit identities. It will also endeavor to briefly identify and discuss various legal constraints that impact the

---

3 See I.R.C. §§ 501(a), 501(c)(3) (1999). Section 501(a) exempts organizations described in section 501(c)(3) from Federal income taxation. Section 501(c)(3) includes corporations organized and operated exclusively for religious, charitable or educational purposes no part of the net earnings of which inures to the benefit of any private shareholder or individual. See I.R.C. § 501(c)(3) (1999). Section 1.503-1(c)(3)-1(e) (1990) of the Treasury Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes if three requirements are satisfied: (1) The organization engages primarily in activities that accomplish exempt purposes, and no more than an insubstantial part of its activities is in furtherance of a nonexempt purpose; (2) the net earnings of the organization do not inure in whole or in part to the benefit of private shareholders or individuals; and (3) the organization does not attempt to influence legislation.


5 See Jane C. Schlicht, Note, Piercing the Nonprofit Corporate Veil, 66 MARQ. L. REV. 134, 140–50 (discussing application of Corporate Identity "Disregard Doctrine" to nonprofit organizations).
proper and efficient governance of religious tax-exempt organizations.

A few caveats should be mentioned at the outset. First, the reader should note that this article is intended to raise and discuss briefly a variety of miscellaneous issues that impact religious, nonprofit corporations; it does not purport to engage in in-depth analysis of any of these issues. Second, the article discusses non-profit corporate and tax law that impacts tax-exempt organizations; it does not attempt to address issues that arise under church law. For these purposes, the article assumes that all of the diocesan entities and affiliated religious organizations are exempt from federal income taxation under the Internal Revenue Code (hereinafter the Code). Religious corporations exempt from income taxation include not only churches but also a myriad of other tax-exempt religious entities that are not treated as churches or houses of worship.

Third, the article will alert readers to issues that might arise as a result of the formation of corporate entities for the purpose of protecting corporate assets. The purpose of the article is to help leaders of churches and other religious entities think about what structures and activities might best enable these corporations to achieve their intended purposes. Although some of the observations might not be comforting or reassuring and some of the restructuring suggested might be difficult to achieve within the constraints of church tradition, history, and law, the proposed solutions shed light on more practical and acceptable solutions for the problems raised by recent changes in law and structure.

One should keep in mind that the church has organized the diocese in several forms. At times the structure has depended on state law and at other times the structure has been dictated by history and tradition. Of the numerous entity forms, trusts, non-profit corporations, corporations sole, and unincorporated

---

6 See I.R.C. §§ 501(a), (c)(3) (1999) and the regulations thereunder.
7 See JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 47 (1995). Section 501(c)(3) grants tax-exemption to qualifying religious organizations beyond the “traditional houses of worship.” Id. at 427. However, only “churches, their integrated auxiliaries and conventions or associations or churches,” in the context of religious entities, enjoy benefits beyond tax-exemption. Id. at 436. “Churches and their integrated auxiliaries are presumed not to be private foundations; are not required to file formal applications in order to be recognized as tax-exempt; and they enjoy special immunities from IRS audits.” Id.
associations are the most common. The article directs its observations at the proliferation of corporations formed for purposes of protecting church assets. It addresses situations where the diocese and the individual parishes are each separately incorporated and situations in which other supporting corporate entities have been formed. The supporting entities include fundraising organizations, special interest welfare corporations, and corporations formed to operate homeless shelters or low-income housing projects. Although most of the proffered comments will apply to limited liability rules or to tax-exempt rules for corporations, many also apply to the other types of entities, or at least to trusts and to unincorporated associations.

Part II of the article discusses the two relevant bodies of law—tax law and non-profit corporate law—and emphasizes recent tax law changes that impose affirmative duties on the governing boards of tax-exempt organizations. Part III outlines the three affirmative corporate duties of loyalty, care, and obedience imposed on corporate principals. Acknowledging the for-profit roots of the duties, Part III examines the interplay between non-profit corporate governance and the imposition and influence of the three obligations. Part IV briefly identifies the board's managerial responsibilities.

I. INCORPORATION OF THE DIOCESE

Three primary reasons exist for creating separate religious, non-profit corporations. The first and most important reason for restructuring is the protection of assets from creditors. A second goal of incorporation, especially in light of the Dallas award, is to attract donors who may be less inclined to give directly to a church due to fear that the church's assets are vulnerable to claims from judgment creditors. A third reason for incorporating separate entities is to attract government grants—for example, government contracts for low-income housing. In these

---


9 See Bruce R. Hopkins, The Law of Tax-Exempt Organizations § 3.2(c), at 42 (7th ed. 1998) (stating advantages of tax-exempt status with regards to grant awards); Allison D. Christians, Breading the Subsidy Cycle: A Proposal for Affordable Housing, 32 Colum. J.L. & Soc. Probs. 131, 143 (1999) (describing non-
situations, the government might not be willing to make the grant unless it can be made to a distinct non-profit corporation.

A. Non-profit Organizations: Fundamental Elements

When contemplating transactions between related religious organizations, it is imperative to analyze three distinct but interrelated doctrines: private inurement, private benefit, and excess benefit transactions. The private inurement and private benefit doctrines are relatively old and established concepts and restrictions. However, the excess benefit transactions doctrine has arisen as an increasingly important concept due to the 1996 enactment of the Taxpayer Bill of Rights II, and Proposed Treasury Regulations issued under that legislation in 1998.\textsuperscript{10} This new legislation imposes affirmative obligations on directors, officers, and trustees of churches, religious organizations, and other public charities exempt under Code section 501(c)(3) and social welfare organizations exempt under Code section 501(c)(4).\textsuperscript{11}

a. Private Inurement

The private inurement doctrine is a broad concept. Although it is not specifically defined in the Code or in the Treasury Regulations, the doctrine of private inurement is generally considered to forbid the flow of the organization's net earnings for non-exempt purposes to those in control of the entity, often referred to as "insiders."\textsuperscript{12} The "insiders" with profit use of Low Income Housing Tax Credit as a mechanism to generate capital for low-income housing projects).


\textsuperscript{11} See I.R.C. § 4958 (1999) (imposing tax on disqualified persons of 25% of excess benefit received). "The term 'excess benefit transactions' means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for use of a disqualified person." I.R.C. § 4958(c)(1) (1999). A party is a "disqualified person" where she, in the 5-year period ending with the transaction, was "in a position to exercise substantial influence over the affairs of the organization." I.R.C. § 4958(f)(1) (1999).

\textsuperscript{12} See I.R.C. § 501(c)(3) (1999) (providing that an exempt organization is one in which "no part of the earnings of which inures to the benefit of any private shareholder or individual"); Treas. Reg. § 1.501(c)(3)-(1)(c)(2) (1990) (stating in part that "an organization is not operated exclusively for one or more exempt purposes if
whom the law is concerned are those individuals who have the ability to direct the organization’s resources to their private use; in other words, those with financial control over the organization. The essence of the private inurement doctrine is to ensure that charitable organizations serve public rather than private interests.

Functionally, the private inurement doctrine represents the substantive dividing line between non-profit corporations and for-profit corporations. But for the inurement principle, non-profit and for-profit corporations are identical. Each type of entity is created in a legal form, pays compensation to employees, and seeks to make a profit, produce goods, and provide services. A non-profit corporation, unlike a for-profit one, may not distribute its profits to those who control it unless the funds are treated as reasonable compensation or payments for services rendered or goods sold. The intended purpose of the restraint is to ensure that the exempt organization’s resources inure to the public rather than to the private benefit of its principals. The proscription against private inurement was, until 1996, absolute, and violation of the prohibition, regardless of the dollar amount, would, in theory (although often not in practice), result in the loss of tax exemption.

b. Private Benefit

A second concept, similar to private inurement, is the private benefit limitation. The two concepts present distinct and separate requirements for exemption. The private benefit

its net earnings inure in whole or in part to benefit private shareholders”).


14 See FISHMAN & SCHWARZ, supra note 7, at 200–27.


16 See I.R.C. § 4958 (1999) and regulations thereunder (substituting intermediate penalty for loss of exempt status).
restriction prohibits the receipt of anything more than incidental private benefits by an individual or entity other than an intended beneficiary of the organization, and other than as reasonable compensation for goods or services. Unlike private inurement, the test for private benefit is not absolute. Any inurement, at least before 1996, would (in theory, but not in practice) result in loss of tax-exempt status. In order for an organization to lose its exempt status under the private benefit doctrine, the private benefits improperly received must be quantitatively and qualitatively more than incidental. Furthermore, unlike the inurement doctrine and the excess benefit doctrine, the private benefit concept operates as to both "insider" and "outsider" private benefit recipients.

It is possible that the private benefit doctrine may be raised in transactions between parishes, where one parish might receive a substantial benefit from another in a non-arm's length transaction. A financially significant transaction between parishes where, for example, a parcel of land is sold well below its fair market value, could give rise to private benefit issues that might jeopardize the tax-exempt status of the seller. The Internal Revenue Service (IRS) might attack the transaction as one in which the intended beneficiaries (the parish and parishioners of the selling parish) are not benefiting from the transaction, because the parish and parishioners of the purchasing parish are improperly receiving a private benefit in the form of a bargain sale. In any event, directors approving a bargain sale of land to a related parish might very well violate

---

17 See American Campaign Academy v. Commissioner, 92 T.C. 1053, 1075–77 (1989) (denying tax-exemption because secondary benefit was not incidental and was more than a substantial part of Academy's activities); G.C.M. 39862 ("determining whether a benefit flowing to private individuals evidences a substantial non-charitable purpose requires balancing of qualitative and quantitative benefits").

18 See HILL & KIRCHTEN, supra note 13, at ¶ 2.03[2] (discussing Service's position on and definition of "incidental" benefits); HOPKINS, supra note 9, at 463 (providing illustration of incidental benefit).

19 See American Campaign Academy, 92 T.C. at 1069 (noting that private benefit prohibition extends to "disinterested persons"); G.C.M. 39862 (Dec. 2, 1991).

20 Although this analysis might be difficult to sustain, it is one of the few avenues for revoking the exemption of the first parish available to the Internal Revenue Service, particularly in light of the Seventh Circuit decision in the United Cancer Council case, which seems to leave authority to penalize the charity and its directors to the states in this situation. See United Cancer Council v. Commissioner, 165 F.3d 1173 (7th Cir. 1999), rev'g and remand'g 109 T.C. 326 (1997).
the duties of care and loyalty, and might be subject to sanctions at the state level. According to non-arm’s length transactions between diocese, parishes, and affiliated organizations should be avoided.

c. Excess Benefit Transactions

The enactment of Code section 4958 under the 1996 Taxpayer’s Bill of Rights II and the release of Proposed Treasury Regulations under that Code section has been one of the most important developments in the law of tax-exempt organizations. Code section 4958 provides an intermediate sanction, which replaces, in most cases involving public charities, the ultimate sanction of revocation of tax-exempt status for private inurement. Until the enactment of section 4958, the only sanction for private inurement was the loss of tax exemption. In fact, both the IRS and the courts viewed the penalty as so severe, that in many cases, it was not applied, and inurement went unpunished. The court’s uneasiness with imposing the ultimate sanction of the private inurement doctrine is evident in the United Way’s ability to retain its tax-exemption notwithstanding Bill Aramony’s well-publicized follies.

Section 4958 imposes a penalty excise tax as an intermediate sanction on section 501(c)(3) public charities (non-private foundations) and on section 501(c)(4) social welfare organizations engaging in certain specified impermissible transactions. Although the primary sanction for inurement in public charities will be the section 4958 tax, the ultimate sanction of revocation of a charity’s tax-exempt status is still available for the most egregious cases of inurement.

In an excess benefit transaction, Code section 4958

---

21 See infra Part III and accompanying notes.
25 See HILL & KIRSCHTEN, supra note 13, at ¶ 2.03[3][f].
mandates that tax sanctions be imposed on “disqualified persons,” similar to “insiders” under the inurement concept, who improperly benefit from the transaction. Of significance is section 4958’s broad definition of “disqualified person,” which encompasses organization managers, such as officers, directors and trustees, highly compensated individuals, and others with “substantial influence” (or substantial financial control) over all or a significant portion of the organization’s affairs. While section 4958(a)(1) imposes a penalty excise tax on the disqualified person receiving the excess benefit, section 4958(a)(2) sanctions organization managers who knowingly approved the improper transaction.

Excess benefit transactions subject to the excise tax include one of two situations: (1) where a disqualified person receives unreasonable compensation or engages in a non-fair market value transaction with the organization or (2) where an organization compensates a disqualified person based, in whole or in part, on the organization’s income from the transaction (i.e., where there is a joint-venture type of financial arrangement between an organization and a disqualified person). The Proposed Treasury Regulations mentioned above clarify many of the issues surrounding the first type of excess benefit transaction. But leave most of the questions surrounding the second type of excess benefit transaction unanswered. Final Treasury Regulations to be issued in the near future will hopefully shed light on the distinction between permissible and improper revenue-based compensation arrangements under Code section 4958.

The amount of the first tier excise tax imposed on a disqualified person is 25% of the excess benefit. Where the disqualified person does not return the excess benefit to the

---

30 See I.R.C. § 4958(a)(1) (1999) (stating in part: “there is hereby imposed on each excess benefit transaction a tax equal to 25% of the excess benefit”).
exempt-corporation in a timely manner, section 4958(b) imposes a second level of tax equal to 200% of the excess benefit received. The tax sanction imposed on an organization manager is equal to 10% of the excess benefit. The tax on managers is capped at $10,000, which seems to be an aggregate cap for tax on all liable managers (with all managers being jointly and severally liable for the total amount of the tax imposed on managers).

For dioceses, what may be most significant is obtaining the advantage of a presumption of reasonableness that shifts the burden of proof of reasonableness to the IRS. There is a rebuttable presumption of reasonableness with respect to compensation and a similar presumption with respect to valuation if the arrangement is approved by a board or a committee thereof composed entirely of individuals unrelated to and not subject to the control of the disqualified person.

To take advantage of the rebuttable presumption of reasonableness, the board or committee should obtain and rely upon appropriate data comparing the salaries of comparable positions in the non-profit and for-profit arenas. The board or committee should also provide adequate documentation for the basis of the determination of reasonableness.

As to the dioceses and their related organizations, there are several aspects of the excess benefit transactions provision that may be relevant to their operations. First, the statute places an affirmative duty on the boards of charitable organizations as defined under section 501(c)(3), including churches and religious organizations, to determine reasonableness of compensation for disqualified persons through comparability studies and to properly document the basis for each determination.

---

31 See I.R.C. § 4958(b) (1999) (stating in part: “in an case in which an initial tax is imposed by subsection (a)(1) on an excess benefit transaction and the excess benefit involved in such transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 200 percent of the excess benefit involved”); Prop. Treas. Reg. §§ 53.4958-1(c)(2)(ii), (iii), 63 Fed. Reg. 41486 (1998) (outlining necessary methods to correct excess benefit transactions within a timely manner).


33 See I.R.C. § 4958(d)(2) (1999) (stating “with respect to any 1 excess benefit transaction, the maximum amount of tax imposed by subsection (a)(2) shall not exceed $10,000”).


board follows these procedures, it can take advantage of the rebuttable presumption that shifts the burden of proof of "reasonableness" to the IRS. Second, the statute penalizes board members (by imposing excise taxes) for failing to properly execute their duty to set reasonable compensation levels. This should send a warning to the dioceses. Third, Proposed Treasury Regulations state that, in order to shift the burden of proof to the IRS, all compensation or valuation decisions with respect to a disqualified person must be made by a board of directors or committee of the board that is "composed entirely of individuals who do not have a conflict of interest with respect to the arrangement of the transaction."\(^{37}\) This provision requires that the board consist of some members who are not related to the disqualified person and not controlled by the disqualified person so that an independent committee can be formed to make compensation and valuation judgments. Fortunately, the Proposed Regulations permit the board to delegate decisions surrounding compensation of disqualified persons to a committee composed entirely of individuals who do not have a conflict of interest, including "other parties" (presumably non-board members), provided that the delegation is permitted under the relevant state law.\(^{38}\) In the event that structuring an impartial board is impossible in certain cases, this provision may be particularly useful to dioceses and their related corporations wishing to take advantage of the rebuttable presumption.

The issue becomes more complicated when dealing with parishes. Under church law and certain state law,\(^ {39}\) it may be impossible to structure an impartial or an independent board with respect to parishes.\(^ {40}\) It might be possible, however, to structure an independent board (or at least a committee of a


\(^{39}\) See, e.g., N.Y. RELIG. CORP. LAW (McKinney 1990) (promulgating the laws for organization of denominational churches).

\(^{40}\) See id. ¶ 91 (describing the "[g]overnment of Roman Catholic churches"); see also Filetto v. St. Mary of the Assumption Church, 305 N.Y.S. 2d. 403, 407 (Sup. Ct. 1969) (discussing composition of parish boards and parishioner's lack of input with respect to naming board members).
board or of "other parties," when permitted under state law), for independent organizations such as fundraising entities.\footnote{See N.Y. RELIG. CORP. LAW § 91.} Under many state laws, creating an independent board could be accomplished for most diocesan corporations. Consider a hypothetical scenario in which the chief executive officer of a fundraising entity is a bishop. If a diocesan administrator and a pastor on the board of the fundraising entity participate in setting the bishop's salary, the rebuttable presumption of reasonableness would be forfeited. In this hypothetical, therefore, it would be desirable to restructure the board or the compensation committee to include some independent members, like parishioners. In doing so, salaries could be set without jeopardizing the favorable presumption that shifts the burden of proof to the IRS.

**II. NON-PROFIT CORPORATE GOVERNANCE**

It is important that religious corporations formed for the primary purpose of protecting church assets adhere to basic corporate rules regarding operations and independence in order to maintain the advantages of limited liability.

The directors of a non-profit corporation are charged with managing the affairs of the organization. This responsibility, with respect to trustees and directors (hereinafter used interchangeably), can be separated into three fiduciary duties: the duty of loyalty; the duty of care; and the duty of obedience.\footnote{See Note, The Fiduciary Duties of Loyalty and Care Associated with the Directors and Trustees of Charitable Organizations, 64 VA. L. REV. 449 (1978) (discussing fiduciary duties of non-profit corporate fiduciaries); DANIEL L. KURTZ, BOARD LIABILITY: GUIDE TO NONPROFIT DIRECTORS 21–22 (1988) (noting legal standards by which directors are judged); HOWARD L. OLECK, NONPROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS § 263 (5th ed. 1988).} The first two duties are derived from the for-profit world while the third is unique to non-profit entities.\footnote{See FISHMAN & SCHWARZ, supra note 7, at 200; see also VICTORIA B. BJORKLUND ET. AL., NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS 413–15 (1997).}
A. Affirmative Duties

a. Duty of Loyalty

The board of directors' duty of loyalty mandates that a director act in a manner that is not harmful to the corporation.\textsuperscript{44} It also requires directors to avoid using their positions improperly to obtain personal benefits or advantages that might more properly belong to the corporation.\textsuperscript{45} In other words, usurping a corporate opportunity or using non-disseminated, nonpublic information to produce financial windfalls for a director would violate the duty of loyalty.\textsuperscript{46} In furtherance of the concept of "undivided" loyalty, the duty requires objective decision making.\textsuperscript{47} The duty of loyalty is violated when conflicts of interest influence the decisions of directors.\textsuperscript{48}

In reality, the most significant considerations in satisfying the duty of loyalty are, in hindsight, whether a particular decision was fair to the organization when it was made, and whether the decision was reached or approved by an impartial board.\textsuperscript{49} The existence of overlapping boards increases the difficulty of achieving an impartial board environment, particularly where the overlap is significant and the entities with overlapping boards engage in transactions together.\textsuperscript{50} Expanding and diversifying boards and eliminating or reducing the overlap will greatly improve an organization's chances of achieving an impartial board environment, engaging in fair

\textsuperscript{44} See Fishman & Schwarz, supra note 7, at 200.

\textsuperscript{45} See Fishman & Schwarz, supra note 7, at 200 (stating that duty of obedience requires that directors adhere to mission or organization).

\textsuperscript{46} See Fishman & Schwarz, supra note 7, at 201–14 (providing personal benefit transaction examples).

\textsuperscript{47} See Bjorklund, supra note 43, at 393.

\textsuperscript{48} See Bjorklund, supra note 43, at 393–94; Bennet B. Harvey, The Public-Spirited Defendant and Others: Liability of Directors and Officers of Not-For-Profit Organizations, 17 J. Marshall L. Rev. 665, 681 (discussing the standards of care and liability applicable to directors of non-profit organizations). It is not necessarily fatal to the transaction or director when conflicts of interest arise. See \textit{id.} at 681–82. While the courts subject self-interested transactions to considerable scrutiny, the Model Business Corporations Act provides a limited window for such deals. See \textit{id.} at 682; see also Fishman & Schwarz, supra note 7, at 202 (providing reasons for allowing limited interested transactions).

\textsuperscript{49} See Fishman & Schwarz, supra note 7, at 203.

\textsuperscript{50} See Harvey, supra note 48, at 705–07 (examining case law dealing with the issue of board member who is on both for-profit and not for-profit corporation).
transactions, and upholding the duty of loyalty.

It is difficult for a director to properly exercise the duty of loyalty to a corporation when a conflict of interest exists. Serving on boards of several organizations that interact with one another can create such a conflict. This is perhaps the most significant issue for the new structures of diocesan corporations. For example, assume a diocese has separately incorporated parishes. In each parish in the diocese, the board of directors or trustees consists of the bishop, the vicar general (or other diocesan administrator), and the pastor of the parish. Thus in each parish in the diocese, two of three directors are identical—the administrator and the bishop, and these two directors generally exercise significant control over the third member of the board. Those same two individuals serve on the board of the diocese. The responsibilities of the bishop and the diocesan administrator would be the same with respect to each parish. It is easy to see the problems created by this structure. It would be difficult, if not impossible, for each of these boards to operate at arm’s length with one another and with the diocese. To have a separate corporation respected for corporate purposes, these entities must operate as distinct entities involved in arm’s length transactions.

Failure to attain a separate corporate identity increases the likelihood that a court will pierce the corporate veil under appropriate circumstances.\(^51\) In the case of a large judgement against a parish or diocese such as the Dallas judgement mentioned above, piercing the corporate veil may result in the loss of parish assets and assets of the diocese itself. In addition, the trustees and directors risk personal liability.\(^52\) This might excite an attorney general or a disgruntled and litigious individual, but it should engender fear in all of those charged with managing religious organizations structured with overlapping boards of this type.

The problems of overlapping boards may be demonstrated when a fundraising corporation is created separate from the diocese and parishes for the primary purpose of soliciting and protecting donations and assuring potential benefactors that

\(^{51}\) See Schlicht, supra note 5, at 140–43 (defining disregard doctrine and examining traditional situations in which court has pierced corporate veil).

\(^{52}\) See Schlicht, supra note 5, at 143–44 (imposing personal liability on members of non-profit where court disregards corporateness).
assets will not be used to satisfy legal fees or damage awards in misconduct cases. The sole function of the fundraising entity is to solicit funds, make grants to the diocese and the parishes, and to expend funds on their behalf. Furthermore, the board of each entity (the fundraising entity, the diocese, and each parish), consists of two of the same three members – the bishop and the diocesan administrator. When faced with an issue, a court might question whether each of the entities has a distinct corporate existence, and whether transactions between the entities can be considered to be at arm's length. After all, precisely the same people who control the grant recipients control the grant maker. If a court concludes that the independent identity of each entity is illusive and that the separateness is a sham, it is more likely, when petitioned by a judgment creditor, to pierce the corporate veil of each organization, enabling the creditor to reach the assets of all of the allegedly separate entities. Under this scenario, the assets of the fundraising entity might end up in the hands of the creditors of any parish or diocese.

A significant protection against violation of the duty of loyalty is the regulation of conflict of interest transactions. Directors who operate in their own self-interests violate their undivided duty of loyalty. Accordingly, the religious organizations at issue should take several steps to ensure that a conflict of interest does not result in the loss of distinct corporate status for one or more of the entities involved.

First and foremost, each entity should adopt a conflict of interest policy outlining acceptable and unacceptable relationships among the organization, its board members and, where relevant, its staff. The policy should require all transactions, including those within an organization, as well as those between parishes, between the parish and the diocese, and between a parish or the diocese and a supporting organization, to

53 See Schlicht, supra note 5, at 140–42.
54 See David B. Rigney, Conflict of Interest Policies and Procedures for Nonprofit Organizations, in Nonprofit Governance: The Executive's Guide 111 (Victor Futter & George W. Overton eds., 1997) (stating traditional remedy for conflict of interest situations are "disclosure and nonparticipation by officer or director in any formal decision concerning a transaction in which he or she may have a conflicting interest"). The conflict of interest policy should specify the following: (1) individuals covered; (2) the scope of activities and relationships covered; and (3) the standard and procedures to follow for any transaction within the scope specified. See id. at 112–13.
be approved by a vote of disinterested, or non-conflicted directors—unless state law prohibits such approval. Interested directors should abstain so as not to taint the transaction. For example, a vote of disinterested directors should be required to approve a grant from a fundraising organization to a related parish or diocese. Otherwise, the entity invites an attack on the grant or transaction by disgruntled litigants or creditors. For this purpose, a director who sits on the board of more than one entity involved in the transaction could be considered interested with respect to the transaction.

The second step that an organization should take to avoid conflicts of interest is to restructure the board in a way that makes arm's length transactions possible. Using the above example, a diocese may accomplish a disinterested structure if the bishop and diocesan administrator serve only on the board of the diocese and not on the boards of the individual parishes. Each parish board would consist of the pastor and three or four parishioners. Under this scenario, each parish would operate, from a corporate structure perspective, independently of one another and of the diocese. The bishop, as well as several community members, could serve on the board of related fundraising entities. In an effort to retain the independence of the community members, they might be appointed by their respective pastors rather than by the bishop. This structure may not be feasible in all situations, but other methods may be available to avoid conflicts of interest and to protect the assets of the organizations. For example, the boards could be expanded so that the interested directors do not constitute the majority. If each parish had a board consisting of the bishop, the vicar general, the pastor and three parishioners, a majority of the directors or trustees would not overlap.

55 See, e.g., N.Y. RELIG. CORP. LAW § 5 (McKinney 1997) (prohibiting certain churches from transferring property without archbishop’s or bishop’s consent).
56 See BJORKLUND, supra note 43, at 393–413. Fairness is the fundamental purpose for disclosing the existence of a conflict and for mandating a disinterested vote. See BJORKLUND, supra note 43, at 395. Where litigants question the validity of a transaction due to the absence of adequate disclosure or disinterested vote the parties to the transaction must prove that the transaction was fair to the corporation. See BJORKLUND, supra note 43, at 404–05.
57 See KURTZ, supra note 42, at 5–7 (describing composition and nature of board).
Another structuring possibility available to eliminate conflicts of interest is to adopt a policy that permits only disinterested directors to vote. Under this policy, the bishop and the diocesan administrator would abstain from any vote involving a transaction with another entity for which they serve as directors. This would further help to ensure, for corporate law purposes, that the separate existence of each diocesan corporation would be respected. Again, as is the case under the New York Religious Corporations Law, this kind of restructuring might not be feasible. It is necessary, however, to create a structure in which a majority of the voting directors are not interested in the transaction. For corporate law purposes, a separate, independent identity must be established for each entity. Nevertheless, it is apparent that the boards of religious non-profit corporations should expand and diversify in order to take advantage of the purposes and benefits that they were intended to provide. Ultimately, restructuring may be crucial to the protection of the assets of parishes and dioceses.

A third step in maintaining distinct legal entities is to respect what will be termed “corporate niceties.” This involves proper corporate maintenance achieved by following the requirements of state law. A non-profit religious organization should properly draft certificates or articles of incorporation and by-laws; maintain adequate records required under state and federal law; file properly prepared and reviewed annual reports; hold regular board meetings; and draft, review and approve minutes of those meetings. Furthermore, financial statements of the organization should be reviewed and approved by all officers and directors. These items provide the necessary paper

---

58 See N.Y. RELIG. CORP. LAW § 5 (McKinney 1997) (requiring transfers of property be approved by archbishop or bishop).
59 See N.Y. NOT-FOR-PROFIT CORP. LAW § 708 (McKinney 1997); see also WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS §4-5, at 137 (5th. ed. 1993) (stating that Model Business Corporations Act requires that “interested directors . . . abstain, and approval by disinterested directors, is requisite when inchoate conflicts become choate”).
60 See BJORKLUND, supra note 43, at 415 (noting that in addition to three duties nonprofit directors must act within confines of state law and purpose of organization).
62 See BJORKLUND, supra note 43, at 331 (noting that the board is responsible for periodic review of financial statements and that some functions of board include establishing operating procedures, budgets, projections and fiscal controls).
trail to legitimize the organization's corporate existence in those situations where it is challenged.

Aside from the threat that the corporate veil will be pierced, there are other reasons for maintaining separate corporate existence and for avoiding conflicts of interest. First, as discussed in more detail in relation to the duty of care, avoiding conflicts protects the judgment of directors and trustees from attack. This is particularly true when corporate decisions have less than favorable results. The business judgment rule shields directors in such situations but it only applies to a director who has made an informed decision in good faith, without a disabling conflict of interest. In the scenario, the business judgment rule can be a valuable source of protection for the decisions of directors.

Second, avoiding conflicts of interest decreases the possibility that a transaction will be set aside or rescinded. For example, if the sale of land between parishes is determined by overlapping boards, or if a director sitting on the boards of both the purchasing and the selling corporation has made the decision as to sale and price, the validity of the sale could be challenged. If the circumstances indicate that the sale was not negotiated at arm's length, a court could set aside the sale. Realistically, if the purchase price is equal to the fair market value, a challenge is unlikely. The fact that conflicted directors vote on a transaction does create a sense of impropriety that could be detrimental should the transaction be challenged.

Third, avoiding conflicts of interest through the creation of a diverse and independent board will enable exempt religious organizations to take advantage of the rebuttable presumption

---

63 See BJORKLUND, supra note 43, at 382 (describing business judgment rule). The business judgment rule "provides that judgments by boards about 'business' matters are presumptively correct and that boards function best when these decisions remain beyond judicial scrutiny except in cases of egregious misconduct." Id.

64 See id.

65 See GREGORY V. VERALLO & DANIEL A. DREISBACH, FUNDAMENTALS OF CORPORATE GOVERNANCE 102 (1996) (stating that transactions entered into with a conflict of interest "will be sustained only if it is objectively and intrinsically fair"); see also GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 31 (George Overton ed., 1993) [hereinafter GUIDEBOOK FOR DIRECTORS] (noting that board must reexamine a transaction after it discovers the proposal was acted upon in ignorance of an undisclosed interest).

set forth in section 4958 of the Code. The presumption shifts the burden of proof from the organization to the IRS. Therefore, conflicts of interest should be avoided, in spite of competing concerns that might arise under the structure of church law. Diversification and expansion are key words that should be kept in mind when determining strategies for avoiding conflicts of interest.

b. Duty of Care

In addition to the fiduciary duty of loyalty, directors are held to a certain degree of care. The duty of care relates to a director's decision-making process, and to the standard of conduct applicable to directors in the discharge of their obligations and responsibilities with respect to non-profit organizations. Directors must discharge their corporate responsibilities "in good faith, and with a certain degree of diligence, attention, care and skill." If a director acts within these parameters, the court will not review the director's action even if it proves disastrous to the organization, as long as there was no fraud, illegality or disabling conflict of interest. Effectively, if the directors exercise their best judgment, they are protected by the best judgment rule, which is a corollary to the business judgment rule used in the for-profit corporate world. In other words, the "duty of care focuses on the manner in which directors exercise their responsibilities rather than on the correctness of a decision." As long as directors remain alert, make informed decisions, and actively supervise corporate operations, they are not likely to violate the duty of care.

The duty of care provides another compelling reason to maintain a diverse and independent board in dioceses and their affiliated entities. To gain the protection of the business judgment rule, directors must abstain from voting when they have a conflict of interest. Thus, an official on the board of a fundraising entity in a diocese who votes to make a grant or to

67 See supra notes 35–40 and accompanying text.
68 FISHMAN & SCHWARZ, supra note 7, at 161.
69 See id.
70 Id.
71 See BJORKLUND, supra note 43, at 394–96; see also GUIDEBOOK FOR DIRECTORS, supra note 65, at 30–31.
sell property to a parish on whose board the official also serves, may not be protected by the business judgment rule should the grant or sale be challenged. Overlapping boards further increase the risk that the overlapping board members will lose the protection of the business judgment rule.

c. Duty of Obedience

To complete the discussion of the fiduciary duties of non-profit board members, it is necessary to discuss the duty of obedience. There is some question as to whether this duty actually exists as a separate duty, or whether it is best described as an element of the duty of loyalty and the duty of care as applied to non-profit organizations. It is a rather nebulous duty to carry out the mission of the organization. The duty of obedience essentially prohibits directors from “deviat[ing] in any substantial way from their duty to fulfill the particular purpose for which the organization was created,” unless, the particular deviation is permitted by law.

For diocesan organizations, issues concerning the duty of obedience primarily arise with respect to the prohibition against private inurement and private benefit found in the tax rules discussed earlier. The duty of obedience requires that the board operate an organization for public, exempt and charitable purposes, rather than for private purposes. Any time that a conflict of interest arises between a board member and the organization, there is a danger that private purposes will be served. This is yet another motivation for maintaining independent boards with some diversity in membership. Diversity enables those with conflicts of interest to abstain from votes that might cause a violation of the duty of obedience.

Obeying the fiduciary duties of loyalty, care, and obedience is paramount to maintaining diocesan organizations that are respected as corporations. Officers and directors of diocesan corporations must keep these duties in mind when acting on

---

72 See, e.g., FISCHMAN & SCHWARZ, supra note 7, at 227–29; BJORKLUND, supra note 43, at 413–14. The duty of obedience requires the board to administer the entity in a manner that ensures that the mission and purpose of the organization is carried out. See FISCHMAN & SCHWARZ, supra note 7, at 227.

73 FISCHMAN & SCHWARZ, supra note 7, at 228.

74 See supra notes 12–21 and accompanying text.
behalf of non-profit corporations. Failure to fulfill these duties could result in the piercing of corporate veils and a failure of the organizations to serve the very purposes for which they were formed.

III. MANAGERIAL TASKS: FURTHERING THE ORGANIZATION'S MISSION

A board's responsibility to manage the affairs of the corporation can be subdivided into many different tasks. While there are far too many to identify and discuss, the final section of the article highlights several of the more important responsibilities.

The fundamental responsibility of the non-profit board is to identify and define the organization's mission. Ideally, the organization should draft and distribute a mission statement to guide both the organization in its activities and the board in its decisions.

A second board responsibility important in achieving and furthering the organization's mission is the selection of officers, particularly the Chief Executive Officer. This applies less to parishes and more to the other types of supporting entities now being created. Setting salaries is another important function of the board. As discussed above, salaries should be set only after conducting proper comparability studies. Under the tax law, a board's failure to properly set salaries can lead to the imposition of penalty excise taxes on both officers and directors.

A third managerial task of directors is to be intimately involved in the strategic planning of the organization. When

---

75 See William G. Bowen, Inside the Boardroom 47–51 (1994); see e.g., Bjorklund, supra note 43, at 330. The board of directors of non-profit organizations play a significant role, even more so then in for-profit entities. See Bjorklund, supra note 43, at 330. Unlike for profit principals, officers of non-profits operate out from under the watchful eye of shareholders and wield broad managerial discretion. Tempered only by the organization's mission, the selection of non-profit principals becomes a distinct and important responsibility.

76 See supra notes 30–36 and accompanying text.


78 See Bjorklund, supra note 43, at 331 (noting that some of the board's internal functions involve "approving long range plans involving, for example, new program initiatives or major modifications of existing programs, resource acquisition, or disposition and new revenue-generating measures . . . ").
board members are selected for expertise, vision, commitment, empathy, and experience, rather than for other reasons, they can contribute in a meaningful and decisive way to the organization's planning and to the achievement of its mission.  

Fourth, directors should review and approve the organization's financial statements. Board members must consider financial oversight in a non-profit organization to be a top priority in order to ensure that the organization will have sufficient resources to accomplish its mission. Board members should be willing and able to review and understand financial statements. Unfortunately, however, this is too often not the case. An organization should consider the responsibilities of its directors and should take the steps necessary to ensure that board members are comfortable and capable in a financial oversight role.

Finally, boards should ensure that the organization's endowment is properly invested by individuals who are competent to make investment decisions. For example, when selecting board members for a diocesan fundraising entity, it would be wise to select one or two individuals with expertise in investing endowments, or at least with sufficient knowledge to enable them to work effectively with investment advisors to maximize the entity's endowment.

CONCLUSION

It is important to emphasize that some of the issues addressed in this article are difficult to resolve in the context of diocesan corporations, affiliated parishes, and supporting corporations. Church law, history, and tradition must be respected in the operation of these corporations. This article's

---

79 See BOWEN, supra note 75, at 51–52.
80 See BJORKLUND, supra note 43, at 331.
81 See, e.g., Smith v. Van Gorkom, 488 A.2d 858, 877 (Del. 1985) (reasoning that the directors' decision was not informed due in part to the fact that they never questioned the Chief Financial Officer and failed to consult with experts).
82 One helpful resource is Understanding Non-Profit Financial Statements—A Primer for Board Members, published by the National Center for Nonprofit Boards.
83 See FISHMAN & SCHWARZ, supra note 7, at 229. Upon delegating investment responsibilities to outside sources, the board maintains the responsibility to review and approve investment strategies and mechanisms. See FISHMAN & SCHWARZ, supra note 7, at 229.
purpose is to convey, in light of the Dallas verdict, that forming separate corporations to protect diocesan assets is extremely useful. These organizations, however, may not achieve their intended purposes unless they are operated as true non-profit, tax-exempt entities. In other words, the organizations must adhere to state corporate laws as well as state and federal tax laws, in addition to church law, in order to take advantage of the protection that civil laws provide.