FIDUCIARY RESPONSIBILITY

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Many persons who give the gift of their time in the United Methodist denomination serve in roles that place them in a position of fiduciary responsibility. Examples of roles in the church that carry a fiduciary responsibility include: board of trustees, finance committee and foundation/endowment board of a local church, district or annual conference; council on finance at the annual conference; directors of other foundations and endowment boards; directors of general agencies; and other roles in which there is a responsibility to manage funds or other assets and direct the work of the organization.

Denominational funds are derived primarily from the contributions of individual donors in local churches. Such funds also may be received by other means, such as pension contributions, profits generated by the sale of materials, gifts and bequests. Those who manage and control denominational funds - or assets acquired from those funds - are trustees of those asset funds, with the obligation to manage and administer those asset funds properly, and direct the work of the agency, organization or group, in accordance with the directives of the General Conference (as embodied in the *Book of Discipline,* the *Book of Resolutions,* and elsewhere, and under secular law) (note: all references in this document to specific paragraphs in the *Discipline* are based on the 1996 *Discipline).*

The secular law imposes two basic duties on all trustees: The duty of loyalty, and The duty of care.

Duty of Loyalty

The duty of loyalty consists primarily of two basic obligations on a trustee. First, the trustee must always take care to be aware of and avoid real or potential conflicts of interest and the appearance of a conflict of interest - and to disclose any potential conflicts of interests that might have an impact on how s/he makes a decision. Second, the trustee must maintain the strict confidentiality of any and all matters that are confidential. A word about each of these obligations is in order.

1. <u>Conflicts of interest</u>

The duty of loyalty requires that a trustee be conscious of the potential for a conflict of interest -
and to act with candor and care in dealing with such situations. When a conflict of interest - or even a potential conflict of interest does arise, the trustee must *disclose the* conflict or potential conflict prior to any discussion of the decision to be made. Preferably, the disclosure should he in writing and given to the secretary of the board. Written disclosure will provide some protection to a trustee who is later challenged on whether the proper

disclosure was made.

In addition, any trustee with an actual - or potential - conflict of interest should abstain from participating in the discussion or vote on the issue in question. If the trustee does not recognize that an agenda item poses a real or potential conflict of interest until the discussion is already underway, s/he should immediately ask for the floor and disclose the newly discovered conflict. In all cases, the trustee should leave the room until the item has been fully discussed and decided. The minutes of the meeting should document that, “Ms. Jones left the room and did not participate in the discussion or vote on the issue because of a conflict of interest.”

Here are some examples of conflicts that might come up in any church board setting:

Ms. Jones has a brother who would very much like to be elected to the board, and he has been working behind the scenes to get his name on the ballot, as well as putting in a plug for himself with Ms. Jones, asking her to help him with her colleague board members (desired result: Ms. Jones should advise the board that she has a conflict of interest and leave the room and not participate in the discussion or vote regarding her brother; she also should refrain from putting in a plug for her brother with her colleague board members);

Mr. Smith has a financial interest in an insurance brokerage firm that is trying to sell the church on buying its insurance through the firm (desired result: Mr. Smith should advise the board that he has a conflict of interest and leave the room and not participate in the discussion or vote regarding the insurance brokerage firm);

Ms. Doe owns 5,000 shares of stock in a particular company and the board is voting on whether to buy a substantial portion of that company’s stock with the monies from a new bequest (desired result: this example does not have a clear-cut answer, but Ms. Doe probably should take the road of caution and advise the board that there is a potential conflict of interest or a perception of a conflict - this disclosure alone ordinarily will be sufficient, without the necessity of Ms. Doe leaving the room, because everyone will be on notice that her vote may be affected even in some small way by her personal ownership of stock; if Ms. Doe is concerned about whether she can be objective then she probably should leave the room and not participate in the discussion or vote regarding the purchase of this company’s a stock; the desired result will vary from one situation to another, depending on whether Ms. Doe’s ownership of stock in the particular company is sizeable enough to have an impact on her ability to be objective - there also will be some situations where the ownership is immaterial, such as in the case of an individual who may own small amounts of stock in many companies through a mutual fund portfolio);

Mr. Lake was denied a loan from First Bank 2 years ago because of some problems in his credit history and has remained very angry with the bank for its decision ever since - the church is deciding whether to switch its business from Second Bank to First Bank (desired result: this example also does not have a clear-cut answer and reflects the not

uncommon problem of personal bias that everyone faces in making decisions from time to time; Mr. Lake probably should advise the board of his personal situation if he is going to stay in the room and participate in the discussion, including the honest disclosure that his feelings about First Bank may or may not be altogether rational and objective).

Certain types of conflicts of interest cannot be resolved simply by disclosure and then leaving the room. Here are two examples:

Ms. Invest, a board trustee, owns or works at the investment firm used by the board to handle its substantial investments; it may be difficult for Ms. Invest to resolve this serious conflict of interest simply by leaving the room for every investment discussion and decision; in all likelihood, she would not be in the room for a significant portion of most meetings. When there are serious conflicts of interest, such as this one, then Ms. Invest may need to make a choice: either leave the board or divest herself entirely from the outside interest that is causing the conflict;

Mr. Estate, a board trustee, is a commercial real estate broker and is trying to convince the board to sell a prime vacant parcel of land for office condominiums and to allow him to be the broker for the sale. This is a serious conflict of interest for Mr. Estate, who should either resign from the board, in order to serve as the broker for this sale, or else refrain from participating in the entire matter - including both the decision to sell the property and participation as broker in the sale. The *Discipline* contemplates certain types of conflicts of interest that cannot be resolved by disclosure. For example, Paragraph 710.4, 710.5, 710.6 and 710.7 address and provide rules for preventing serious conflicts of interest for individuals who serve on general agencies (for example, no person who receives compensation for services rendered or commissions of any kind from an agency shall be eligible for voting membership on that agency). These are excellent rules to use for other types of organizations and boards, even where the *Discipline is* silent. In summary, a trustee is strictly prohibited from making any decision that is - or may have the appearance of being - in his/her own best interests rather than the interests of the organization or group on whose behalf s/he is making a decision. Courts often deal harshly with those who deal for their own benefit in a trust situation. Justice Benjamin Cardozo, in the case of Meinhard v. Salmon, 249 N.Y. 458, 464 (1928), made a now famous and often quoted statement concerning the high standards that trustees must uphold:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden by those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty. . . This statement highlights the seriousness with which courts look at potential breaches of loyalty on the part of trustees. There is a misperception by some that the courts will not deal as harshly with those who breach this standard in a religious organization, since the courts in general dislike judicial intrusions into the affairs of churches.

Beware: the courts in today's world are likely to find self-dealing by religious leaders to be just as intolerable as any other type of self-dealing, especially in light of the media attention that has been focused on serious financial wrongdoings in several religious organizations in recent years.

2. <u>Confidentiality</u>

The duty of confidentiality is also an easy one to understand. A trustee must not disclose information about the organization's activities unless the information is already known by the public or becomes a matter of public record. A trustee is not a spokesperson for the board or organization, unless specifically given that role for a particular purpose.

This duty can be especially important to maintain in the United Methodist denomination because of the open meeting rule in Paragraph 721 of the *Discipline* on closed sessions. Trustees should carefully consider whether to call for a closed meeting, pursuant to the requirements of Paragraph 72 1, when addressing confidential agenda items. And, when a meeting is closed pursuant to Paragraph 72 1, it is important to wait to distribute confidential documents after the meeting has been closed, because any document disseminated in an open meeting shall be considered public under this *Disciplinary* requirement.

The *Discipline* also requires that a report on the results of a closed session is to be made immediately upon its completion, or as soon thereafter as is practicable. It is important that the trustees consider the nature of such a report prior to reopening the session (for example, who will make the report, what will be included in the content of the report, and when the report will be made). This type of discussion also will serve as a useful guide for all of the trustees on what they should and should not say when asked by friends, colleagues and others about the action taken. The minutes of the meeting also need to reflect the closed session (for example: In accordance with Paragraph 721 of the 1996 *Discipline,* the [committee/board] by a 3/4 vote of all members present at the meeting voted to close the session, for the purposes of discussing one of the topics provided in Paragraph 721. Upon completion of that discussion, the open session was resumed and the [committee\board] announced that ...

Duty of Care

The second primary duty of all trustees is the duty of care. This duty means that a trustee is obligated to act in the best interests of the organization at all times. This obligation is straightforward and easy to understand if the trustee asks himself/herself one question before making any decision: what would be the best decision under the circumstances for this organization at this time and place? Another way to look at this obligation is to ask oneself.

How would I act if this were my parents' money - or my own assets - at stake in this decision?

The duty of care has three basic components. First, a trustee must be reasonably informed about an issue before making a decision. Second, a trustee must act as a reasonably prudent person would act under the same or similar circumstances. Third, the trustee must use independent judgment in reaching decisions. A word about each of these components is in order.

1. Reasonably Informed

The duty to be reasonably informed means that a trustee should not make decisions in the dark. A trustee should read - and understand - agenda materials that are provided; should ask questions; and should speak up and request more time to learn more if s/he feels that more information or time is needed in order to be reasonably informed.

The duty to be informed also means that a trustee should be diligent in attending meetings. Trustees who do not have time to attend meetings should resign from the board. Also, trustees should not simply show up and remain silent. Every trustee has something to contribute to the group and should make an effort to contribute his/her special gifts; no one trustee has an edge on knowing or understanding an issue.

The duty to be informed also means that trustees should request and receive regular reports on the investment and administration of funds. Absent timely and accurate information, a board cannot carry out its fiduciary responsibility.

2. Reasonably Prudent Person

This duty means that a trustee should act with such care as an ordinarily prudent person would act under similar circumstances in the management of his/her own affairs. This duty also means that a trustee should always act in good faith. Good faith is an easy concept for volunteers in a religious organization to understand: in simplistic terms, it means following your conscience. If a trustee has information that would be important for the other trustees to know in reaching a decision, then the trustee should disclose that information; knowingly remaining silent is not an act of good faith. Given the facts available at the time of the decision, a trustee is required to use his/her best judgment in making a decision. A trustee is not held responsible for facts that s/he could not have known at the time the decision was made. Decisions made in good faith and with reasonable care should be upheld if challenged.

Trustees are not required to make the very best decision in all cases. The courts readily acknowledge that trustees are humans and from time to time will make mistakes. Trustees are “forgiven” for mistakes as long as they are reasonably informed in making their decisions, act in good faith, participate in the decision making process, and use independent judgment in reaching their decisions.

3. Independent Judgment

Trustees are not absolved from their fiduciary duty by delegating their responsibility to others. While it is appropriate to rely on the information and expertise of others (such as staff, outside advisors; and others who may have special information or expertise on a particular matter), a trustee must reasonably believe that the source of information is reliable and competent and exercise his/her own independent judgment in evaluating the merits of the information.

For example, a board that is entrusted with a large sum of money may - and in some cases should - engage an investment advisor to assist with investment decisions. However, the board still has the ultimate responsibility for the funds, even if the investment advisor is given broad powers to make investments on behalf of the body. And, the board needs to take care that the investment advisor is properly selected - and then evaluated on a regular basis (for example: annually or bi-annually). Persons who are engaged to handle funds should be trustworthy and competent in the areas in which they are being engaged.

In addition, any trustee who has any reason to believe that someone in the organization or on the board has committed some financial wrongdoing has a duty to investigate the situation to find out whether or not there is in fact something going on. A trustee in this situation should be careful not to slander anyone by accusations of theft or other wrongdoing but should take steps to find out whether there is any truth to the reasonable suspicion. If a trustee has any question about how to proceed based on a "hunch" or "suspicion," s/he should confer with legal counsel for assistance.

Likewise, any trustee who has reason to believe that funds are being handled sloppily, or proper reporting of investments is not being made, or funds are being expended contrary to the organization's (or General Conference's) guidelines, then s/he has a duty to inquire why proper actions are not being taken.

A Final Word About Making Decisions on Behalf of a Church Entity and Expenditures and Investment of Denominational Funds Fiduciaries in the church generally have broad powers and the ultimate legal responsibility with regard to actions of the organization and expenditures and investment of denominational funds entrusted to them. It is very easy in a church to become so comfortable that the importance of the fiduciary duty is forgotten - the church is an extended family, and decisions are often made informally and with the same love and care that decisions are made in one's family. At the same time, the sense of family and belonging can make it easy to forget that serving on a board is important "business" - and that the decisions being made should be carefully considered, as business decisions. In addition, it is important that fiduciaries in the Church keep in mind the United Methodist Social Principles as they make decisions on behalf of any given Church entity. The *Discipline* encourages decisions to be made in support of the goals outlined in those Social Principles (see, for example, Paragraph 2532.5). With respect to expenditures and investments, it is important to remember that the use of funds may be unrestricted - but, in other cases, the use of funds may carry certain restrictions,

either from the *Discipline,* organizational rules, restrictions given by donors, or based on secular law. It is imperative that trustees know and understand the restrictions on the use of funds. Here are some common examples:

Paragraph 2542 of the *Discipline* prohibits the use of the proceeds of the sale of a church building for the current or budget expenses of a local church;

Paragraph 2503 requires that United Methodist real property be held in trust for the denomination; Where donors have restricted the use of a fund to a particular purpose - or have stated that only the income may be expended - a board that has agreed to accept the gift is legally bound to administer it according to the donor's restrictions (unless the donor's restrictions are illegal or contrary to public policy);

A bequest earmarked for the development of Sunday school curriculum materials for elementary age children may not be diverted to use for other purposes, such as administrative expenses, college scholarships, or the purchase of a new organ. Boards should periodically review (on a regular schedule, such as annually or biannually) the administration of donor-restricted funds, to ensure that the funds are being handled in accordance with the restrictions. It is the trustees who ultimately are responsible for the appropriate use of these gifts. Some proposed gifts and bequests are so encumbered with restrictions that administration is extremely costly, difficult, or even impossible. A board has the authority to accept or reject proposed gifts, and rejection should be considered when a board anticipates significant problems in administering a highly restricted gift or bequest. Breach of Duty What happens when a trustee breaches his/her fiduciary duty? In a worst case scenario, when a trustee has knowledge of wrongdoing and fails to act; has a significant conflict of interest and fails to disclose the conflict or recuse himself/herself from participation in a decision; or knows that the board is making a huge mistake and fails to say anything to his/her fellow trustees that would assist them in avoiding the mistake, then the trustee may be exposed to individual, personal liability if there is a lawsuit challenging the board's decision. For example, if a trustee has knowledge that one of the organization's major investments is about to go sour and fails to disclose his/her information to the board, costing the organization hundreds of thousands of dollars, then that trustee may be held personally liable for this failure to disclose important information that would have assisted the board in making a proper decision that would have saved the investment dollars.
Trustees should not spend their time worrying about their potential personal liability exposure, because this type of worrying can interfere with a trustee's ability to do the job with ease and comfort. However, trustees should always be mindful that they have a higher duty of responsibility than the ordinary public and, in essence, they are obligated to be "good stewards" with the church's money. Trustees must always be attentive to the high degree of trust and responsibility they share with their denominational staff in regard to the stewardship of church funds.

Additional Reading Materials

For additional reading on fiduciary duty, there is an excellent publication available from the American Bar Association: Guidebook for Directors of Nonprofit Corporations, George W. Overton, Editor, Section of Business Law, American Bar Association (1993), ISBN 0-89707-892-6. The ABA charges a nominal fee for the publication. Inquire at Publications Planning & Marketing, American Bar Association, 750 North Lake Shore Drive, Chicago IL 60611.

Disclaimer

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