



CHAPTER SEVEN

LEGAL ISSUES IN CHURCH DISSOLUTION & MERGER

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The purpose of this chapter is to provide incorporated local churches¹ with a basic overview of steps that may be required should a church decide to dissolve, merge with another church, or sell its assets. Laws governing these various transactions involve federal laws applying to nonprofit organizations as well as state laws. Failure to adhere to these laws can affect a church's tax-exempt status and may result in post-transaction liability for officers and directors of the church. The applicable laws will vary from state to state, and this memorandum should not be considered legal advice or a comprehensive guide to the legal requirements for engaging in such transactions. Churches contemplating dissolution, merger, or sale are advised to seek experienced local counsel in their own jurisdictions well in advance of the transaction. This is especially important when amendments to a church's constitution or by-laws may be necessary, or the church is subject to deed restrictions that may make transfer of property complicated.

I. CORPORATE DISSOLUTION

Churches that are incorporated under state law must follow their state's requirements for dissolution. These requirements will vary by state, but will likely involve the following steps.

A. DISSOLUTION STEPS

1. Voting members must adopt a resolution of dissolution.

The resolution of dissolution is generally proposed and adopted by the governing body of the church before the church members vote on it. The voting members of the church must be notified in writing of a meeting to vote on dissolution. The number of votes required to adopt the resolution of dissolution may vary by state law and also by the church's bylaws. For example, some states may specify that at least half of voting members present at the meeting must vote in favor of adopting the resolution. But a church's bylaws may require a supermajority vote, such as a two-thirds vote of all members, in favor of the resolution on dissolution. So long as the state law permits a church to specify a different number of voters for approval, the church bylaws must be followed.

2. Creditors of the church must be notified of the dissolution and all corporate debts must be paid.

The church must notify all creditors that the church will be dissolving. The church must pay all of its debts prior to dissolution. The church should keep detailed records of the creditors notified and the debts paid.

3. Notify the state department of taxation and other applicable entities that the church will be dissolving.

States have laws requiring all dissolving business entities to notify the state department of taxation and other departments, like the department of jobs and family services, to ensure that businesses do not owe taxes or unemployment insurance contributions. While churches may not be subject to certain taxes or to unemployment insurance requirements, they must still follow the procedures outlined under state law to notify these departments that the church is closing and avoid being subject to any future assessments or penalties. Some states require that a business that is closing receive a certificate from the department of taxation that confirms the business has no outstanding tax liabilities before the state will accept a business's articles of dissolution.

4. Remaining assets must be distributed to a tax-exempt organization as set forth in the church's governing documents.

If there are assets left over after paying creditors, the assets must be disposed of as indicated in the church's governing documents. A church's governing documents should specify that any remaining assets will be distributed to a named tax-exempt organization, such as the Conference in which the church is located. In this way, the church's members can ensure that the assets of the church will continue to support a purpose substantially similar to the mission of the dissolving church.

Although churches are not required apply to the IRS for tax-exempt status, churches are required to meet many of the same obligations as other organizations that are tax-exempt under I.R.C. § 501(c)(3). This includes ensuring that tax-exempt assets remain permanently tax-exempt. Accordingly, under no circumstances may assets of a dissolving church be transferred or paid to any individual or to a non-exempt organization. The IRS requires that all tax-exempt organizations have a provision in their governing documents that upon dissolution, their assets will be distributed to another tax-exempt organization. In some states, the operation of state laws will accomplish this purpose, but in others, a church needs an adequate dissolution provision in its organizing document to satisfy its obligations under I.R.C. § 501(c)(3). The following is an example of a clause that will satisfy the IRS:

Upon the dissolution of (church name), or disaffiliation of (church name) with the United Church of Christ, assets shall be distributed to the _____ Conference of the United Church of Christ, or to Local Church Ministries, A Covenanted Ministry of the United Church of Christ or its successor organization, which are organizations with an exempt purpose under section 501(c)(3) of the Internal Revenue Code. Changes to this bylaw require a vote in favor by two-thirds of the members of the congregation.

Some churches may have real property that is subject to mortgages, restrictive covenants, or deed restrictions that govern to whom the property may be transferred or the use of the property. Additionally, some churches may have provisions in their governing documents that create a trust on the real property in favor of another setting of the national church or another organization. Ideally, the effect of these restrictions should be determined well in advance of a church's decision to dissolve so that appropriate measures can be taken to avoid or mitigate undesirable outcomes. These situations are heavily dependent on the exact language of the restriction and on state law, and a church should consult with a local experienced attorney for advice on these matters.

5. Prepare the articles of dissolution.

The articles of dissolution (sometimes called the certificate of dissolution) must contain certain information required by state law. This generally includes the name of the church corporation, a statement that a resolution of dissolution was adopted and the manner in which such resolution was adopted, the names and addresses of the officers and directors, the identity of the statutory agent, and the date of dissolution. The articles of dissolution may also need to include a representation that all debts have been paid and that all assets have been transferred to an appropriate organization specified by the church's organizing documents. The articles may have to be signed by an officer or director of the corporation. The secretary of state may have a form for this purpose.

6. File the articles of dissolution.

The articles of dissolution are filed with the secretary of state's office in the state where the church is incorporated. The secretary of state may issue some acknowledgment of the dissolution, or may indicate that the church is dissolved in its business records. The church may be required to publish a notification of its dissolution in a local publication.

Generally, the board of directors continues to act as the board of directors until the business affairs of the corporation are completely wound up. The board should ensure that this happens as speedily as possible.

B. CONTINUED LIABILITY OF THE CHURCH AFTER DISSOLUTION

1. Liability of Officers and Directors

In general, officers, directors, and members of an incorporated church are not liable for the obligations of the church corporation, either before or after dissolution. An exception exists, however, where an officer or director has personally guaranteed any liability of the church corporation. Such a debt, if not paid, remains the personal obligation of the officer or director guaranteeing it.

A number of circumstances, too numerous to list here, exist under which officers and directors may face personal liability for their conduct both while the church is operating as a going concern and after dissolution. For example, officers and directors may be liable for obligations of the church if they voted or agreed to a distribution of church assets upon dissolution without ensuring that all debts of the church were paid. Officers and directors may also be liable for voting or agreeing to a distribution of assets that is contrary to law or to the church's bylaws (either upon dissolution or otherwise). State laws on the liability of officers and directors for particular conduct, such as gross negligence or reckless misconduct, may vary. Some states may place limitations on this liability.

2. Liability of the Church

After properly dissolving, a church may face claims for injuries that occurred prior to its dissolution but of which the church was not informed until after dissolution. If the assets of the church have been properly distributed, the person bringing the claim may have no recourse unless the church had an insurance policy in effect at the time that covered the claim. Insurance policies vary widely in whether they are "claims made" policies, which cover claims while the policy is in effect regardless of when the injury occurred, or "occurrence" policies, which cover injuries that occurred while the policy was in effect. Dissolving churches should ensure that copies of the church's insurance policies are permanently maintained in a safe location.

II. CHURCH MERGER

A church may choose to merge with another church. This process also requires a board resolution and a congregational vote. When churches merge, usually one church, the "surviving entity," absorbs another church, the "merging entity." The resulting combined church is a single entity that is responsible for all of the liabilities of both churches that were not satisfied prior to the merger. Because the resulting entity remains responsible for all liabilities of both churches, churches contemplating merger should engage in a discernment process that includes not only considering whether the church congregations could successfully join in worship and mission, but also a legal and financial due diligence process designed to fully inform both churches about the true state of each church's business affairs. Church merger may be an option for a church that has liabilities that prevent the church from dissolving under state law, such as an unresolved lawsuit or a mortgage on real property. Each church contemplating merger should retain a separate attorney to assist with the due diligence process and advise the church on the merger agreement and the articles of merger that the state will require.

III. CHURCH ASSET PURCHASE

A church may choose to purchase the assets of another church, or to sell some or all of its assets to another church. The church purchasing assets may or may not absorb the congregation of the selling church, depending on the goals and vitality of both churches. A church selling all of its assets dissolves after the sale through the formal dissolution process described above.

Assets include both real estate and personal property of the church, such as computers, vehicles, and furniture. Often, liabilities are attached to assets that either travel with the asset or must be satisfied prior to the sale. For

example, a church may have an outstanding mortgage loan on its building. The selling church must either pay the loan prior to the sale of the building, or the purchasing church must assume the loan. For this reason, creditors holding security interests in assets must be notified of the sale and may have the right to approve or reject the terms of the asset purchase agreement.

An asset sale may be a useful option for a church that wishes to dissolve but does not have cash available to pay its debts prior to dissolution. The asset sale will free up cash, allowing the church to satisfy its outstanding debts so that it may dissolve under state law. Churches contemplating an asset sale for this purpose should consult an attorney and an accountant to ensure that the appropriate legal and financial requirements are met.

¹ Unincorporated churches may dissolve according to their bylaws. Unincorporated churches should ensure that assets are distributed to a non-profit organization to maintain a tax-exempt status.



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