

PART

Creation of a Nonprofit Organization

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Nonprofit Organizations—Generally

1.1 What is a *nonprofit organization*?

The term *nonprofit organization* is a misleading term; regrettably, the English language lacks a better one. It does not mean that the organization cannot earn a profit. Many nonprofit organizations are enjoying profits. An entity of any type cannot long exist without revenues that at least equal expenses.

The easiest way to define a nonprofit organization is to first define its counterpart, the *for-profit organization*. A for-profit organization exists to operate a business and to generate profits (revenue in excess of expenses) from that business for those who own the enterprise. As an example, the owners of a for-profit corporation are stockholders, who take their profits in the form of dividends. Thus, when the term *for-profit* is used, it refers to profits acquired by the owners of the business, not by the business itself. The law, therefore, differentiates between profits at the entity level and profits at the ownership level.

Both for-profit and nonprofit organizations are allowed by the law to earn profit at the entity level. But only for-profit organizations are permitted profits at the ownership level. Nonprofit organizations rarely have owners; these organizations are not permitted to pass along profits (net earnings) to those who control them.

Profits permitted to for-profit entities but not nonprofit entities are forms of private inurement. That is, *private inurement* refers to ways of transferring an organization's net earnings to persons (insiders) in their private capacity. The purpose of a for-profit organization is to engage in private inurement. By contrast, nonprofit organizations may not engage in acts of private inurement. (Economists call this fundamental standard the *nondistribution constraint*.) Nonprofit organizations are required to use their profits for their program activities. In the case of tax-exempt nonprofit organizations, these activities are termed their *exempt functions*.



NOTE: The prohibition on private inurement does not mean that a nonprofit organization cannot pay compensation to its employees and others. The law requires, however, that these payments be reasonable.

Consequently, the doctrine of private inurement is the essential dividing line, in the law, between nonprofit and for-profit organizations.

1.2 What is the difference between the terms *not-for-profit* and *nonprofit*?

Although the term *not-for-profit* organization is sometimes used instead of *nonprofit* organization, as a matter of law, the terms are not synonymous. People use the two terms interchangeably in good faith, but the proper legal term is *nonprofit organization*.

The law uses the term *not-for-profit* to apply to an activity rather than to an entity. For example, the federal tax law denies business expense deductions for expenditures that are for a not-for-profit activity. Basically, this type of activity is not engaged in with a business or commercial motive; a not-for-profit activity is essentially a hobby.

The term *not-for-profit* is often applied in the nonprofit context by those who do not understand or appreciate the difference between profit at the entity level and profit at the ownership level.

1.3 What is an *unincorporated nonprofit association*?

An *unincorporated nonprofit association* is defined as an organization consisting of members joined by mutual consent for a common, nonprofit purpose. Historically, people have formed associations in order to share interests or further common goals. Small religious organizations, for example, may not feel they have the financial or human resources to obtain and maintain corporate status.

Just because an association takes a less formal approach to its formation does not mean that it should grow haphazardly. Members of unincorporated associations should be aware that without some formal planning, associations risk running afoul of the law, which is the most important shortcoming of this form of self-government. Historically, an unincorporated association was not liable for actions of its members because it was not a legal entity subject to suit. However, the trend in the law is to allow even unincorporated associations to sue and be sued. Furthermore, individual members may be liable for acts of other members under the traditional law of agency.

The Internal Revenue Code restricts tax-exempt status to corporations, community chests, funds, and foundations organized and operated exclusively for religious and other charitable purposes, but the IRS construes the term *corporations* to include unincorporated associations. Internal Revenue Code Section 7701(a)(3)

defines *corporation* to include associations. As such, the exemption available to charitable nonprofit corporations and religious nonprofit corporations is available to unincorporated associations that meet the other conditions required by the federal tax law for exempt status. A church, for example, that is not incorporated is, by definition, an unincorporated association.

1.4 How is an unincorporated association started?

Being incorporated becomes particularly useful once an association starts to grow in membership and resources. Some states do not have laws that govern unincorporated associations in general, although they may have statutes concerning specific types of associations. Even if there are no state statutes dealing with unincorporated associations, some legal principles may be applicable to such groups. Every association should have a constitution (also referred to as the *charter* or the *articles of association*; what name it is called is of no legal significance). The constitution is the document containing a statement of the association's purpose and an outline of the procedures it will follow.

Some states require an unincorporated association to file its constitution with the secretary of state, the county clerk, or another state or local agency. The constitution should be tailored to the particular organization, but most constitutions contain the following:

- Organizational purpose
- Organizational structure
- Qualifications for membership
- Methods for appointing leaders
- Internal governance guidelines, such as frequency of meetings and authority for handling finances
- Tax status

1.5 What is the role of a lawyer who represents one or more nonprofit organizations?

Overall, the role of a lawyer for a nonprofit organization—sometimes termed a *nonprofit lawyer*—is no different from that of a lawyer for any other type of client. The requisite skills are to know the law, represent the client in legal matters to the fullest extent of one's capabilities and energy, and otherwise zealously perform legal services without violating the law or breaching professional ethics.

1.6 Is a “nonprofit lawyer” necessary to form a nonprofit organization or religious nonprofit organization?

No. But, use of a nonprofit lawyer is helpful. The typical lawyer today is a specialist; the nonprofit lawyer is no exception. Nonprofit law is unique and complex; the lawyer who dabbles in it does so at his or her peril. A lawyer may be the best

of experts on family law or real estate law, and know nothing about nonprofit law. The reverse is, of course, also true: the nonprofit lawyer is likely to know nothing about personal injury or labor law.

The first task of a lawyer is to “know the law.” That is literally impossible: No lawyer can know all of the law. The nonprofit lawyer, like any other lawyer, needs to be just as aware of what he or she does *not* know as of what is known. The nonprofit lawyer may be called in as a specialist to assist another lawyer, or, occasionally, a nonprofit lawyer may turn to a specialist in other fields that can pertain to nonprofit entities, such as construction law or bankruptcy law.

Some lawyers represent nonprofit organizations that have a significant involvement in a field that entails a considerable amount of federal and/or state regulation. These lawyers may know much about the regulatory law in a particular field, yet know little about the law pertaining to nonprofit organizations as such.

1.7 How should the lawyer representing a nonprofit organization be compensated?

There is nothing unique about the compensation arrangements for lawyers representing nonprofit organizations (other than the fact that the compensation may be comparatively lower). Most lawyers representing nonprofit organizations will determine their fee solely on an hourly rate for the time expended. In these circumstances, the client is entitled to a statement (usually monthly) that clearly reflects the time that was expended, who expended it (including paralegals), and the hourly rates. These statements usually itemize expenses to be reimbursed.

It is a good practice to provide the nonprofit organization client, at the outset of the relationship, with a letter that spells out the billing practices.

Some lawyer–client relationships in the nonprofit realm are based on a retainer fee arrangement. The client pays the lawyer a fixed fee for a stated period, irrespective of the volume of services provided. The retainer arrangement gives the nonprofit organization a budgeting advantage: It knows what its legal fee exposure will be for the period. A lawyer gains an advantage of cash flow. Both parties should monitor the arrangement on an ongoing basis—the lawyer to ward off undercompensation and the nonprofit organization to avoid overcompensation.

The fee arrangement may blend a retainer with additional hourly rate fees for specified services.

Other fee relationships include bonuses and contingencies. A nonprofit organization should always be mindful of the private inurement constraint—the rule that compensation, including legal fees, must always be reasonable.

1.8 How is a nonprofit organization started?

Nearly every nonprofit organization is a creature of state law (or District of Columbia law). Thus, a nonprofit organization is started by creating it under the law of a state.

There are only four types of nonprofit organizations: corporations, unincorporated associations, trusts, and limited liability companies. The document by which a nonprofit organization is formed is generally known as its *articles of organization*. For a corporation, the articles are commonly called *articles of incorporation* or *certificate of formation*. For an unincorporated association, the articles are in the form of a *constitution*. The articles of a trust are called a *trust agreement* or *declaration of trust*.

Most nonprofit organizations also have a set of *bylaws*—the rules by which they are operated. Some organizations have additional rules: codes of ethics, manuals of operation, employee handbooks, and the like.

A nonprofit organization formed as a corporation commences its existence by filing articles of incorporation with the appropriate state. Some states require the filing of trust documents. It is rare for a state to require the filing of a constitution or a set of bylaws as part of the process of forming the organization. (Bylaws and similar documents may have to be filed under other state laws, however.)



NOTE: These observations pertain to the filing of the document as part of the process of creating the nonprofit organization. A nonprofit that is soliciting contributions is likely to have to file its articles of organization and bylaws in every state in which it is fundraising, as part of the solicitation registration requirements. A religious nonprofit organization, however, may be exempted from solicitation registration requirements based on constitutional, first amendment, and free exercise of religion grounds.

Following the creation (and, if necessary, the filing) of the articles of organization, the newly formed entity should have an organizational meeting of the initial board of directors. At that meeting, the directors will adopt a set of bylaws, elect the officers, pass a resolution to open a bank account, and attend to whatever other initial business there may be.

1.9 How does a nonprofit organization incorporate?

The state usually has a form set of articles of incorporation. A lawyer who knows something about nonprofit organizations can prepare this document or the incorporators can do it themselves. They need to agree on the organization's name, state the corporate purposes, list the names and addresses of the directors, name a registered agent, and include the names and addresses of the incorporators. The incorporators are the individuals who signed the articles.

This is not entirely a matter of state law. What is or is not in a set of articles of incorporation can be determinative of whether the organization is able to become tax-exempt under federal law. The two most important elements are the statement of the organization's purposes and, in the case of charitable entities, the inclusion of a clause preserving income and assets for charitable purposes.

1.10 How does a nonprofit organization decide in which state to incorporate?

Generally, a nonprofit organization is formed in the state in which it is to be headquartered. Most frequently, this is the state in which those who are forming the entity and who will be operating it are residents and/or maintain their offices. An organization can be formed in only one state at a time.

A nonprofit organization (particularly a nonprofit corporation) must be qualified to do business in every state in which it has an operational presence. In some states, for purposes of this qualification, the solicitation of gifts (irrespective of the means) is considered doing business.

Any entity that is formed in one state (the domestic state) and is doing business in another state (a foreign state) is regarded, by the latter state, as a foreign corporation.

1.11 How does a nonprofit organization qualify to do business in another state(s)?

A nonprofit organization qualifies to do business in another state by filing a *certificate of authority* to do business in the state. The process of obtaining this certificate is much like incorporating in a state. Also, the entity is required to have a *registered agent* in each state in which it is certified to do business (as well as in the domestic state).

The law of each state should be checked to see what persons qualify to be registered agents. An organization that is doing business in several states may find it more efficient to retain the services of a commercial firm licensed to function as a registered agent in all of the states.

1.12 Who are the *incorporators*?

Under the typical legal requirement around the country, anyone who is 18 years of age and a U.S. citizen can incorporate a nonprofit corporation. Each state's law should be confirmed on that point, however. The initial board members can be the incorporators. Many states require three incorporators.

Some groups are very sensitive to the matter of who is listed as an incorporator. They see the articles of incorporation as being of great historical significance to the organization—a document to be preserved and treasured for posterity. Others prefer to let the lawyers working on the case be the incorporators. No particular legal significance is attached to service as an incorporator.

Generally, directors and officers of the organization can also be incorporators. However, the law of the appropriate state should be reviewed.

1.13 Who owns a nonprofit organization?

For the most part, a nonprofit organization does not have owners who would be comparable to stockholders of a for-profit corporation or general partners in a partnership.

There are some very limited exceptions: A few states allow nonprofit corporations to be established with the authority to issue stock. This type of stock is not paid dividends, because that would contravene the prohibition on private inurement. The stock can be transferred to others, however, by sale, gift, or otherwise.

1.14 Who controls a nonprofit organization?

It depends on the nature of the organization. Usually, control of the nonprofit organization is vested in its governing body, frequently termed a *board of directors* or *board of trustees*. Actual control may lie elsewhere, with the officers or key employees, for example. It is unlikely that control of a large-membership organization would be with the membership, because that element of power is too dissipated. In a small-membership entity, control may well be with the membership.

1.15 What is a registered agent?

Typically, the registered agent must be either an individual who is a resident of the state or a company that is licensed by the state to be a commercial registered agent.

The registered agent functions as the corporation's point of communication to the outside world. Any formal communication for the corporation as a whole is sent to the registered agent. Thus, if the state's authorities want to communicate with the corporation, they do so by contacting its registered agent. If someone wants to sue the corporation, the agent is served with the papers.

The registered agent as such is not a director or officer of the corporation. Thus, the agent has no exposure to liability for the corporation's activities. The agent would be held liable for his or her own offenses, such as breach of contract.

1.16 Can the same individual be a director, officer, incorporator, and registered agent?

Yes, unless state law expressly forbids such a multi-role status, which is unlikely. The registered agent, if an individual, must be a resident of the state in which the entity is functioning, but the requirement of residency is not applicable to the other roles.

1.17 What are the types of nonprofit organizations?

Just as the corporation became the preeminent mode for conducting business in the United States, the nonprofit corporation is the most widely chosen platform from which to advance nonprofit activities. With the inherent flexibility to embrace any number of activities and the benefits and familiarity of the corporate modality, the nonprofit corporation can readily underpin such charitable entities as churches, charities, schools, and orphanages, to name but a few examples. Every endeavor should consider early on the legal form the nonprofit organization will take. This is, as noted, basically a matter of state law. (Again, this assumes that the organization is not formed by statute or ordinance.)

Tax-exempt, nonprofit organizations generally are of three types:

1. Corporation
2. Unincorporated association
3. Trust

There are other forms of tax-exempt organizations, such as a limited liability company or a professional corporation. These forms are, however, rare in the nonprofit world.

1.18 How is the appropriate form of nonprofit organization selected?

Several factors need to be considered in deciding which form a nonprofit organization should select, particularly if tax-exempt status is desired. Generally, the pivotal factor concerns the personal liability of the organization's trustees, directors, and officers. The corporate form has the advantage of shielding board members and officers (and perhaps key employees) from most types of personal liability. With the corporation, liability, if any, is generally confined to the corporation; that is, it does not normally extend to those who manage it, regardless of the organization's chosen purposes and activities.

Another factor is the state law that would be applicable to the entity under consideration. The law of a state usually provides answers to many of the questions that inevitably arise when forming and operating a nonprofit organization. These answers are most likely found in the state's nonprofit corporation act. The specific degree of regulation, the limitations imposed on operating the entity, and the public perception the entity desires factor into both the form and location of the entity chosen.

A third factor is privacy. In exchange for the grant of corporate status, the state usually expects certain forms of compliance by the organization, such as adherence to rules of operations, an initial filing fee, annual reports, and public disclosure requirements. There rarely are comparable filing requirements for trusts and unincorporated associations. Although articles of incorporation are public documents, trust documents and unincorporated association constitutions often are not.

In most cases, federal tax law is silent as to the form of tax-exempt organizations, expressing no preference or limitation with respect to the three types. In a few instances, however, a specific form of organization is required to qualify under federal law as a tax-exempt organization.

1.19 Can the name of a nonprofit organization be protected?

A nonprofit organization has the same set of rights available to protect its name as any other enterprise. Certain limited protection arises simply by selecting the name to incorporate under and using the name, while more extensive protection may be sought through formal applications for trademark and service mark protection.

Churches, for example, often have similar names derived from prevalent principles or themes contained in the Bible or other sacred texts. The preferred and most extensive protection for the name of a church, religious organization, or other nonprofit organization is protection under federal trademark law. A trademark is defined by the Federal Trademark Act as “any work, symbol, or device, or any combination thereof adopted and used by a manufacturer and sold by others.” Trademark protection is thus available when an organization has put a symbol, mark, name, or the like, to use in commerce, such as publishing literature with the mark affixed to such literature, thereby identifying the source of the goods and services. Obviously, the same principle holds equally true for any number of nonprofit entities such as counseling centers, correspondence schools, private elementary or secondary schools, nursing homes, radio or television stations, publishers, or the like.

U.S. and state common law protects the names of existing enterprises against unauthorized use of confusingly similar names by other organizations. Most states prohibit new corporations from using names that are identical or confusingly similar to those of existing organizations registered in that state. The names of nonprofit organizations have been protected as well on the basis of one or more of the following theories: the applicable nonprofit corporation statute protecting preexisting registered names, application of the name protection provided by business corporation statutes to nonprofit corporations when the state nonprofit law does not specifically provide such protection, the common law of unfair competition, as well as trademark protection.

Some states have a statute protecting the names of religious corporations, such that a church’s name will be protected against later use of the same or a confusingly similar name in either of two ways: The state official (typically the secretary of state) charged with the duty of reviewing applications for incorporation rejects the application of an organization whose name is either identical or deceptively similar to the name of an existing corporation, or if the state recognizes the corporate status of an organization whose name is either identical or confusingly similar to an existing entity’s, the offended corporation may seek legal recourse to stop further use of the name.

1.20 What does the term *ultra vires act* mean?

Ultra vires is a Latin phrase that literally means “beyond the power.” *Ultra vires* describes acts attempted by a corporation that are beyond the scope of powers granted by the corporation’s governance documents, the laws authorizing its formation, or similar founding documents. Acts attempted by a corporation that are beyond the scope of its charter are void or voidable. Even though dicta supporting the view that *ultra vires* acts were totally void appeared in many cases, most courts actually adopted the view that such acts were voidable rather than void.

The concept of *ultra vires* can arise in the following kinds of activities in some states:

- Loans to officers or directors
- Charitable or political contributions
- Pensions, bonuses, stock option plans, job severance payments, and other fringe benefits
- Guaranty of indebtedness of another