CHAPTER ONE

Federal and State Law Fundamentals

For decades, the law in the United States concerning governance of nonprofit organizations was almost solely confined to state (and, to some extent, local) law. While this state of affairs is rapidly changing, with the matter of nonprofit organizations' governance becoming a province of federal (mostly tax) law, many of the underlying fundamental principles remain those formulated (and once seemingly resolved) at the state law level.

§ 1.1 STATE LAW OVERVIEW

There are essentially seven bodies of state law concerning the organization and operations of nonprofit organizations'. Most of the state law principles pertaining to nonprofit organizations governance are found in the nonprofit corporation acts[1] and the charitable solicitation acts.[2]

(a) Types of Nonprofit Organizations

Most nonprofit organizations are formed as one of three types: corporation,[3] trust,[4] or unincorporated association.[5] It is possible to have a tax-exempt, nonprofit limited liability company.[6] Occasionally, the U.S. Congress "charters" (that is, creates by legislation) a nonprofit organization.[7]

The application for recognition of tax exemption filed by most organizations seeking to be tax-exempt charitable entities[8] (Form 1023) graphically depicts these types. It asks if the filing organization is one of the four types, then, in bold print, directs the entity to not file the application if it is not.[9]

1. See § 1.1(b).
2. See § 1.1(c).
3. See § 1.2(b).
4. See § 1.2(a).
5. *Id*.
6. See *Law of Tax-Exempt Organizations* § 4.4(d).
7. See, e.g., § 3.11.
8. That is, organizations that are tax exempt pursuant to Internal Revenue Code section (IRC §) 501(a) because of description in IRC § 501(c)(3). See *Law of Tax-Exempt Organizations*, Part Three.
9. Form 1023, Part II. See *Law of Tax-Exempt Organizations*, App. D, p. 1123.

Nonprofit, tax-exempt organizations, as part of the process of their establishment, prepare (and sometimes file with a state) *articles of organization*.[10] The nature of these articles will depend, in large part, on the type of nonprofit organization. If the nonprofit organization wants to be tax-exempt under the federal tax law, it usually will be required to meet an *organizational test*.[11]

(b) Nonprofit Corporation Acts

Nearly every state has a *nonprofit corporation act*. The few states that do not have such a statute require nonprofit corporations to fare as best they can by using what is applicable in the statutory law applicable to for-profit business corporations. Most of the states with a nonprofit corporation act have based their law on a model nonprofit corporation act.[12]

(c) Nonprofit Trust Statutes

Nearly every state has a body of statutory law applicable to *charitable trusts*. Many private foundations, for example, are trusts. These laws frequently impose fiduciary standards and practices that are more stringent than those for nonprofit corporations and entail an annual filing requirement. A nonprofit organization that is a trust is formed by the execution of a *trust agreement* or a *declaration of trust*.

(d) Unincorporated Associations

To the uninitiated, a nonprofit corporation and a nonprofit unincorporated association look alike. An unincorporated association is formed by the preparation and adoption of a *constitution*. The contents of a constitution are much the same as those of articles of incorporation. Likewise, the bylaws of an unincorporated association are usually the same as those of a nonprofit corporation.

(e) Charitable Solicitation Acts

A majority of the states have adopted comprehensive *charitable solicitation acts* for the purpose of regulating fundraising for charitable purposes[13] in their jurisdictions. A few states have not enacted any form of charitable solicitation act. The remaining states (including the District of Columbia) have elected to regulate charitable fundraising by means of differing approaches.

The various state charitable solicitation acts are (to substantially understate the situation) diverse. The content of these laws is so disparate that any implication that it is possible to neatly generalize about their assorted terms, requirements, limitations, exceptions, and prohibitions would be misleading. Of even greater variance are

10. See § 1.2(a); *Law of Tax-Exempt Organizations* § 4.2.
11. *Id*. § 4.3.
12. Section III, Part 13, of Independent Sector's Panel on the Nonprofit Sector, *Strengthening Transparency, Governance and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector* (June 2005) ("Nonprofit Panel's Final Report"), includes a summary of the Revised Model Nonprofit Corporation Act (at 76-77). See § 3.12.
13. The concept of *charitable* for purposes of state charitable solicitation acts is usually substantially broader than the concept used in the federal tax law. See *Law of Fundraising* § 3.2(a).

the requirements imposed by the many regulations, rules, and forms promulgated to accompany and amplify the state statutes.[14] Nonetheless, some basic commonalities can be found in the comprehensive charitable solicitation acts.

The fundamental features of many of these charitable fundraising regulation laws are a series of definitions of various terms; registration or similar requirements for charitable organizations; annual reporting requirements for charitable organizations; exemption of certain charitable organizations from all or a portion of the statutory requirements, registration and reporting requirements for professional fundraisers; registration and reporting requirements for professional solicitors; requirements with respect to the conduct of charitable sales promotions; record-keeping and public disclosure requirements; requirements regarding the contents of contracts involving fundraising charitable organizations; a wide range of prohibited acts; registered agent requirements; rules pertaining to reciprocal agreements; investigatory and injunctive authority vested in enforcement officials; civil and criminal penalties; and other sanctions.[15]

(f) Tax Exemption Laws

State law typically provides for tax exemption, from income or ad valorum tax, for a variety of nonprofit entities in the jurisdiction. Usually, the criteria for this exemption are identical to the federal law requirements; some states impose qualifications in addition to the federal ones. Tax exemption may also be available in connection with sales,[16] use, tangible personal property, intangible personal property, and real estate taxes.

(g) Charitable Deduction Laws

Most states' laws provide for a charitable contribution deduction for the making of gifts of money or property to charitable organizations.[17] Usually, the criteria for this deduction are identical to the federal law requirements; some states impose qualifications in addition to the federal ones.

(h) Other Statutory Law

In addition to the panoply of the foregoing bodies of law, nonprofit organizations may have to face other state statutory or other regulatory requirements. These include:

- A state's nonprofit corporation act, which has registration and annual reporting requirements for foreign (out-of-state) corporations that are *doing business* within the state.[18] For example, it is not clear whether, as a matter of general

14. An attempt has been made to resolve this problem by adoption of *uniform annual reports* in many of the states. Some states, however, have added material to the "uniform" form, thereby somewhat returning matters to the original (and confusing) state of affairs. See *Law of Fundraising* § 3.22.
15. Each of these elements in a comprehensive state charitable solicitation act is detailed in *Law of Fundraising*, Chapter 3.
16. A state sales tax exemption relates to the *payment* of these taxes, not necessarily to the *collection* of them when it is the nonprofit entity that is the seller of goods or services.
17. See, in general, *Law of Charitable Giving*.
18. See *Law of Fundraising* § 3.23.

law, the solicitation of charitable contributions in a foreign state constitutes doing business in the state.[19] Some states provide, by statute, that fundraising is the conduct of business activities in their jurisdictions. If the solicitation of charitable contributions were declared, as a matter of general law, to be a business transaction in each of the states, the compliance consequences would be enormous, considering the fact that nearly every state has a nonprofit corporation act. This type of a requirement would cause a charitable organization that is soliciting contributions in every state to register and report more than 90 times each year, not taking into account federal and local law requirements!

- A state's insurance law, which may embody a requirement that a charitable organization writing charitable gift annuity contracts[20] obtain a permit to do so and subsequently file annual statements.
- A state's *blue sky statute* regulating securities offerings, which may be applicable to offers to sell and to sales of interests in, and the operation of, pooled income funds.[21] These laws may also apply with respect to charitable remainder annuity trusts and unitrusts.[22]
- A state's law prohibiting fraudulent advertising or other fraudulent or deceptive practices.[23]
- A state's version of the Uniform Supervision of Trustees for Charitable Purposes Act, which requires a charitable trust to file, with the state attorney general, a copy of its governing instrument, an inventory of the charitable assets, and an annual report. Of similar scope and effect are the state laws that invest the state attorney general with plenary investigative power over charitable organizations.[24]

19. One court observed that "[i]t is doubtful . . . whether the solicitation of funds for a charitable purpose is, to use the statutory words, the `carrying on, conducting or transaction of business' " (Lefkowitz v. Burden, 254 N.Y.S.2d 943, 944-945 (1964)). A subsequent court opinion, however, suggested that the solicitation of funds constitutes doing business in a state (Commonwealth v. Events International, Inc., 585 A.2d 1146, 1151 Pa. 1991)).

    Clearly, a charitable organization organized in one state and maintaining an office or similar physical presence in another state is doing business in the latter state. The general rule is that merely mailing charitable solicitation material into a state is not doing business in that state, although a contrary approach can be established by statute or regulation. In many states, the determination as to whether an organization is doing business in a state is under the jurisdiction of the secretary of state, whereas the registration and reporting requirements of a charitable solicitation act are administered by the attorney general. In some states (such as California), a determination that a charitable organization is doing business in the state leads to a requirement that the organization file for and receive a ruling as to its tax-exempt status in the state (or else be subject to state taxation). Thus, fundraising in a state can entail an obligation on the part of the charitable organization to file with three separate agencies in the state.
20. See *Law of Charitable Giving*, Chapter 14.
21. See *id*., Chapter 13.
22. See *id*., Chapter 12. In general, Horner and Makens, "Securities Regulation of Fundraising Activities of Religious and Other Nonprofit Organizations," XXVII *Stetson L. Rev.* (No. 2) 473 (Fall 1997).
23. E.g., People v. Gellard, 68 N.E. 2d 600 (N.Y.1946).
24. In addition to these state law requirements, there are hundreds of county and city charitable solicitation ordinances.

§1.2 FORMATION OF ORGANIZATION

The nature of governance of a nonprofit, tax-exempt organization is dependent in part on the type of the entity.[25] (For tax exemption to be available, there must be a separate legal entity.[26])

(a) Articles of Organization

As noted, the document by which a nonprofit organization is created is known generically in the parlance of the federal tax law as the *articles of organization*.[27] Usually, there is a separate document containing more specific rules pursuant to which the organization conducts its affairs; this document is most often termed the *bylaws*.[28] A nonprofit organization may also develop other documents governing its operations, in the form of various policies, procedures, codes, handbooks, and/or manuals.[29]

The types of articles of organization for each type of nonprofit organization are:

- Corporation: articles of incorporation
- Unincorporated association: constitution
- Trust: declaration of trust or trust agreement
- Limited liability company: agreement of members

(b) Articles of Incorporation

A typical nonprofit corporation act requires the organization that is to be incorporated to prepare and file *articles of incorporation* that address the following subjects:

- The name of the organization
- A general statement of its purposes
- A statement as to whether the organization has members
- A statement as to whether the organization can issue stock
- The name(s) and address(es) of its initial director(s)
- The name and address of its registered agent
- The name(s) and address(es) of its incorporator(s)
- Provisions reflecting any other state law requirements

Frequently, although state law does not require it, the articles of incorporation will include provisions referencing the applicable federal tax law requirements. For example, an organization intending to be a tax-exempt charitable entity[30] must have

25. See § 1.1(a).
26. See *Law of Tax-Exempt Organizations* § 4.1(a), text accompanied by notes 19–23.
27. See § 1.1(a).
28. See § 1.2(c).
29. See, e.g., Chapter 7.
30. See *supra* note 8.

a *dissolution clause* (that is, a provision preserving the net income and assets of the organization for charitable purposes in the event of its liquidation or dissolution).[31]

(c) Bylaws

The bylaws of an incorporated nonprofit organization will usually include provisions with respect to:

- Its purposes (these are often restated in the bylaws)
- The election (or appointment or ex officio positions) and duties of its directors
- The election and duties of its officers
- The role of its members (if any)
- Meetings of members and directors, including dates, notice rules, quorum requirements, and voting
- The role of executive and other committees
- The role of its chapters (if any)
- The function of affiliated organizations (if any), such as ex officio positions
- A conflict-of-interest policy (if not in a separate document)[32]
- The organization's fiscal year

A repeat of the provisions referencing the applicable federal tax law requirements may be included in a set of bylaws.

(d) Other Governing Instruments

The articles of organization and bylaws (if any) of a nonprofit organization that is not a nonprofit corporation may, and in some instances must, partake of elements of the articles of incorporation and bylaws of a nonprofit corporation. As noted, for example, a constitution is likely to be similar to a set of articles of incorporation.[33]

(e) Selection of Entity Form

Those in the process of establishing a nonprofit organization thus must decide which of the four forms of entity to select. The principal factors to take into account in this regard are the exposure of members of the governing body to personal liability; the answers to questions regarding management and administrative operations that may be provided by state law; general familiarity with the entity form; state law registration and reporting requirements; and federal tax law considerations.

(i) Personal Liability. The corporate and limited liability company forms are the only elements of entity that provide the advantage of shielding board members from most types of personal liability that may arise because of service on the board. Liability, if any, is generally confined to the organization; that is, it does not normally extend to those who manage it. Thus, trustees of trusts and directors of

31. See *Law of Tax-Exempt Organizations* § 4.3.
32. See § 6.3(b).
33. See § 1.1(d).

unincorporated associations do not have this "corporate veil" to protect them. The corporate form is likely to be preferable in this regard because of the vagaries of formation of a nonprofit organization as a limited liability company.[34]

(ii) Answers to Questions. The statutory 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 (assuming there is one) and thus are technically applicable only if the entity is a nonprofit corporation. Some examples are:

- How many directors must the organization have? What are their voting rights? How is a quorum ascertained? How is notice of meetings properly given? What is the length of their terms of office? Are there term limits?
- What officers must the organization have? What are their duties? What is the length of their terms of office? Are there term limits? Can an individual simultaneously hold more than one office?
- How frequently must the governing board meet? Must the board members always meet in person, or can the meetings be by telephone conference call or video teleconferencing? Can the board members vote by mail or by means of unanimous written consent?[35]
- If there are members, what are their rights? When must they meet? What notice of the meetings must be given?
- What issues must be decided by members (if any)? By directors?
- May there be an executive committee of the governing board? If so, what are its duties? What limitations are there on its functions?
- What about other committees? Is there an audit committee? What are the responsibilities of each committee? Does the organization have an advisory committee?
- How are the organization's governing instruments amended?
- How must any merger involving the organization occur?
- What is the process for dissolving the organization? What are the requirements for distribution of its assets and net income on the occasion of a dissolution?

If the organization is not a corporation, these and other questions are usually unanswered under state law. The unincorporated organization may make an effort to

34. Generally, limited liability companies are not as conducive to operation as a nonprofit entity as a corporation. Although most states have a nonprofit corporation act, they do not have statutes governing a nonprofit limited liability company. In addition, a limited liability company must be formed with members, unlike a nonprofit corporation (which often is formed without members, instead opting for a self-perpetuating board). Federal tax law considerations can be more awkward for the operation of a limited liability company as a nonprofit entity. The IRS only recently began to recognize limited liability companies as tax-exempt organizations and more closely scrutinizes the applications for recognition of exemption of these types of entities. In addition, a limited liability with more than one member must file a special election to "check-the-box" to be taxed as a corporation; otherwise, it will be taxed as a partnership with its income flowing through to its members.

35. A generally applicable rule forbids directors from voting by proxy.

add to its rules the answers to all of the pertinent questions (assuming they can be anticipated) or live with the uncertainties.

(iii) Familiarity. People are more familiar with corporations than other forms of entities. Thus, if the nonprofit organization is a corporation, more persons will understand the nature of the entity. In general, the world in which the nonprofit organization will be functioning is comfortable with the concept of a corporation. Trusts are also well known, particularly in the private foundations and other estate planning areas, although they are less known and used than corporations. Unincorporated associations are the least used (and least understood) of these entities.

(iv) Registration and Reporting. Incorporation entails an affirmative act of a state government: it "charters" the entity (by issuing a certificate of incorporation or document by a similar name). In exchange for the grant of status as a corporation, the state expects certain forms of compliance by the organization, such as adherence to its rules of operations, an initial filing fee, annual reports, annual fees, and compliance with public disclosure requirements. These costs are frequently nominal, however, and the reporting requirements usually are not extensive. Rarely are there comparable filing requirements for trusts and unincorporated associations. Although articles of incorporation and annual reports are public documents, trust documents and unincorporated association constitutions often are not. Thus, one of the principal reasons for use of the trust form is privacy.

(v) Federal Tax Law Requirements. In most instances, the federal tax law is silent as to the form of nonprofit, tax-exempt organizations; most of them can select from among the four types. In a few instances, however, a specific form of organization is required to qualify under federal law as a tax-exempt organization. As illustrations, an instrumentality of the United States[36] and a single-parent title-holding organization[37] must, pursuant to the federal tax law, be formed as corporations, while entities such as supplemental unemployment benefit organizations,[38] Black Lung benefit organizations,[39] and multiemployer plan funds[40] must be formed as trusts. A multiple-parent title-holding organization[41] can be formed as a corporation or a trust.

The trust form for a nonprofit organization is rarely the appropriate choice except for certain charitable entities (most notably, private foundations), some labor organizations, and certain funds associated with employee plans. This form is also used when creating charitable giving vehicles in the planned giving setting, such as charitable remainder trusts[42] and charitable lead trusts.[43] By contrast, for example, membership organizations are ill-suited to the trust form.

The principal problem with structuring a nonprofit organization as a trust is that most state laws concerning trusts are written for the regulation of charitable trusts. These rules are rarely as flexible as contemporary nonprofit corporation acts; the rules frequently impose fiduciary standards and practices that are more stringent than

36. See *Law of Tax-Exempt Organizations* § 19.1.
37. See *id*. § 19.2(a).
38. See *id*. § 18.4.
39. See *id*. § 18.5.
40. See *id*. § 18.7.
41. See *id*. § 19.2(b).
42. See *Law of Charitable Giving*, Chapter 12.
43. See *id*., Chapter 16.

those for nonprofit corporations. The trust form may, however, provide more privacy to the founders of a trust and certainly makes amendment of the terms of the entity more difficult (often accomplished only by court order). It is unusual—although certainly permissible—for the trustee or trustees of a trust to adopt a set of bylaws.

The term *unincorporated association* employs the word *association* for a reason: these entities are usually membership-based. That is, societies and the like are often formed without the formalities of incorporation.

A nonprofit corporation and a nonprofit unincorporated association may look alike. A membership association has many of the same characteristics, whether or not incorporated. The contents of a constitution are much the same as the contents of a set of articles of incorporation. Bylaws for an unincorporated association look much like those of a nonprofit corporation.

§1.3 BOARD OF DIRECTORS BASICS

The fundamentals of the law concerning the boards of directors of nonprofit organizations include the nomenclature assigned to the group, the number of directors, the origin(s) of the director positions, the control factor, the scope of the board's authority, and the relationship to the officer positions.

(a) Nomenclature

State law generally refers to the individuals who are responsible for the affairs of nonprofit organizations as *directors*. Some tax-exempt organizations use other terms, such as *trustees* or *governors*. Generally, organizations are free to use the terminology they wish; if the entity is a corporation, however, it may have to use the term *director* in its articles of incorporation, then define it in the bylaws.

The choice of term is not usually a matter of law. Some organizations prefer to refer to their governing board as the *board of trustees*. (Technically, only a director of a trust can be a trustee, but that formality has long since disappeared.) This is particularly the case with charitable and educational institutions. Schools, colleges, and universities, for example, favor this approach.

Where organizations are related,[44] this terminology can be used to reduce confusion. For example, in an instance of a tax-exempt membership association and its related foundation, the board of the former may be termed the *board of directors* and the board of the latter the *board of trustees*.[45]

This governing board may have within it a subset of individuals who oversee the operations of the organization more closely and frequently than the full board. This group of individuals is usually termed the *executive committee*. A few exempt organizations use this term to describe the full governing board.

(b) Number

A tax-exempt organization—irrespective of form—must have one or more directors or trustees. State law typically mandates at least three of these individuals,

44. See *Law of Tax-Exempt Organizations*, Chapters 28, 29.
45. See, e.g., Hopkins, *The Tax Law of Associations* (Hoboken, NJ: John Wiley & Sons, 2006), Chapter 8.

particularly in the case of nonprofit corporations. Some states require only one. Some nonprofit organizations have large governing boards, often to the point of being unwieldy. (State law does not set a maximum number of directors of nonprofit organizations.) Federal law does not address this subject.[46]

The optimum size of a governing board of a nonprofit organization depends on many factors, including the type of organization involved, the nature and size of the organization's constituency, the way in which the directors are selected, and the role and effectiveness of an executive committee (if any). In some instances, particularly in the case of trusts, there may be an institutional trustee.

(c) Origin(s) of Positions

The board of directors of a nonprofit organization can be derived in several ways; in addition, these ways can be blended. The basic choices are election by the other directors (a self-perpetuating board), election by a membership, selection by the membership of another organization, selection by the board of another organization, ex officio positions, or a blend of two or more of the foregoing options.

If there are bona fide members of the organization (such as an association[47]), it is likely that these members will elect some or all of the members of the governing board of the entity. This election may be conducted by mail ballot or voting at the annual meeting. It is possible, however, for a nonprofit organization with a membership to have a governing board that is not elected by that membership.

In the absence of a membership, or if the membership lacks a vote on the matter, the governing board of a nonprofit organization may be a *self-perpetuating* board. With this model, the initial board continues with those it elects and those elected by subsequent boards.

Some boards have one or more *ex officio* positions. This means that individuals are board members by virtue of other positions they hold.[48] These other positions may be those of the organization itself, those of another organization, or a blend of the two.

In the case of many nonprofit organizations, the source of the membership of the board is preordained. Examples include the typical membership organization that elects the board (such as a trade association, social club,[49] or veterans' organization[50]); a hospital,[51] college,[52] or museum[53] that has a governing board generally reflective of the community; and a private foundation[54] that has one or more trustees who represent a particular family or corporation.

46. See, however, § 5.2.
47. See *Law of Tax-Exempt Organizations*, Chapter 14.
48. Despite widespread belief to the contrary, this term has nothing to do with whether the individual in the position has the right to vote. Absent a provision in the document to the contrary, those holding office in this manner have the same voting rights as others on the board.
49. See *Law of Tax-Exempt Organizations*, Chapter 15.
50. See *id*. § 19.11.
51. See *id*. § 7.6(a).
52. See *id*. § 8.3(a).
53. See *id*. § 8.3(b).
54. See *id*. § 12.1.

(d) Control Factor

With the rare exception of the stock-based nonprofit organization,[55] no one *owns* a nonprofit entity. *Control* of a nonprofit organization, however, is another matter. Certainly, the governing board of a nonprofit organization controls the organization (at least from a law standpoint).

There are, nonetheless, other manifestations of this matter of control. One is the situation where an individual or a close-knit group of individuals wants to control a nonprofit organization. This can be of particular consequence in the case of a single-purpose organization that was founded by an individual or such a group. Those who launch and grow a nonprofit organization understandably do not want to put their efforts and funds into formation and development of the organization, only to watch others assume control over it and remove them from the organization's management. Systems are available to facilitate this type of control.

The seven alternatives to achieve this end are:

1. *Trust.* Most individuals in this position assemble a board of friends and family members, and hope that trust and loyalty will prevail. Usually, they do. Occasionally, however, there is internal conflict, a new majority emerges, and the founder or founders are ousted.
2. *Superterm.* Some individuals attempt to create for themselves a term longer than that of the others. Sometimes, an effort is made to have a term for life. This approach usually is untenable under state law.
3. *One director.* A founder of a nonprofit entity can form it in a state that requires only one director, then if necessary qualify it in the state in which it will operate.
4. *Membership classes.* One technique is to have two classes of board members: Class A and Class B. Class A consists of the founders; Class B is everyone else on the board. The governing instrument is written in such a way that certain major decisions (such as expenditures in excess of a set amount or dissolution of the organization) cannot be approved without a majority vote of those in Class A.
5. *Entity membership.* Another technique is to establish the organization as a membership entity and to have only the founders as members. The member/founders have the authority to elect the board members—and to remove them.
6. *Stock.* In a few states, a nonprofit organization can issue stock. Such an entity can be formed with the founders being the sole shareholders. The shareholders would have the authority to elect and remove board members.
7. *Advisory committee.* The governing board can be confined to a select few, coupled with an advisory committee. The latter body is a group of individuals who are not on and do not substitute for the board of directors but provide policy and/or technical input in advancement of the organization's programs. Because members of an advisory committee lack voting rights, their number is governed only by what is practical. Committee members serve without the

55. A few states permit a nonprofit corporation to issue non-dividend-paying stock, as an ownership/control technique.

threat of personal liability that may accrue to the organization's directors and officers (assuming their role is, in fact, only advisory), and without incurring the larger set of responsibilities shouldered by the directors. Moreover, with an advisory committee, an organization can surround itself with luminaries in the field.

Those involved with nonprofit organizations will discover that techniques such as those described above in items 2 to 6 seem feasible in theory but rarely work in practice. This is because these approaches are, as a matter of group dynamics, divisive and likely to cause more difficulties than they resolve. In the end, usually the first option is selected, perhaps augmented with the seventh.[56]

(e) Scope of Authority

The directors are those who set policy for the organization and oversee its affairs; actual implementation of plans and programs and day-to-day management are left to officers and employees. In reality, however, it is difficult to mark a precise line of demarcation where the scope of authority of the board of directors stops and the authority of other managers begins. (In the parlance of the tax law, trustees, directors, officers, and key employees of an organization are *managers* of the entity.[57])

Frequently, authority of this nature is resolved in the political arena, not the legal one. It may vary, from time to time, as the culture of the entity changes. In some organizations, the directors do not have the time or do not want to take the time to micromanage; others restrain themselves from doing so (and still others do not). Often, the matter comes down to the sheer force of personalities. In some organizations, the most dominant manager is the executive director, rather than the president or chair of the board.

(f) Other Considerations

The board of directors of a nonprofit organization may decide to have a chair (or chairperson, chairman, or chairwoman) of the board. This individual presides over board meetings. The chair position is not usually an officer position (although it can be made one). The position may (but need not) be authorized in the organization's bylaws.

Some organizations find it useful to stagger the terms of office so that only a portion of the board need be elected or re-elected at any one time, thereby providing continuity of service and expertise. A model in this regard is the nine-person board with three-year terms for members; one-third of the board is elected annually.

A board of directors of a tax-exempt organization usually acts by means of in-person meetings where a quorum is present. Where state law allows, the members of the board can meet via conference call (a call where all participants can hear each other) or by unanimous written consent. These alternative procedures should be authorized in the organization's bylaws (indeed, that may be a requirement of state law).

56. All of this should be contrasted with the IRS's view of application of the private benefit doctrine (see § 5.21(d)).
57. See, e.g., *Law of Tax-Exempt Organizations* §§ 12.2, 21.3.

Unless there is authorization in the law (and there is not likely to be), the directors of a tax-exempt organization may not vote by proxy, mail ballot, e-mail, or telephone call (other than by a qualified conference call). Members of an organization have more flexibility as to voting than members of the board of the organization. For example, usually they can vote by mail ballot and by use of proxies.

(g) Relationship to Officers

Nearly every tax-exempt organization has officers.[58] A prominent exception is the trust, which usually has only one or more trustees. As with the board of directors, the scope (or levels) of authority of the officers of an organization is difficult to articulate. In the case of a nonprofit organization that has members, directors, officers, and employees, setting a clear distinction as to who has the authority to do what is nearly impossible. General principles can be stated but will usually prove nearly useless in practice.

For example, it can be stated that the members of the organization (if any) set basic policy and the board of directors sets additional policy, albeit within the parameters established by the membership. The officers thereafter implement the policies, as do the employees, although this is more on a day-to-day basis. Yet the reality is that, at all levels, policy is established and implemented.

The officers of a tax-exempt organization are usually elected, either by a membership or by the board of directors. In some instances, the officers of an organization are ex officio with, or are selected by, another organization. The basic choices as to the origin(s) for officer position are election by a membership; election by the directors, who are elected by the members; election by the directors, who are a self-perpetuating board; election (or appointment) by the board of another organization; or a blend of two or more of the foregoing options.

§ 1.4 PRINCIPLES OF FIDUCIARY RESPONSIBILITY

Out of the common law of charitable trusts has evolved the concept that a director of a tax-exempt organization, particularly a charitable entity, is a fiduciary of the organization's resources and a facilitator of its mission. Consequently, the law imposes on directors of exempt organizations standards of conduct and management that comprise *fiduciary responsibility*.

Most state laws, by statute or court opinion, impose the standards of fiduciary responsibility on directors of nonprofit organizations. A summary of this aspect of the law stated: "In many cases, nonprofit corporation fiduciary principles govern the actions of the organization's directors, trustees, and officers, and charitable trust law governs the use and disposition of the assets of the organization." This summary added: "These laws generally address issues such as the organization's purposes and powers, governing instruments (such as articles of organization and bylaws), governance (board composition, requirements for board action, and duties and standards of conduct for board members and officers), and dedication of assets for charitable uses

58. In general, see § 2.2.

(including a prohibition against the use of assets or income for the benefit of private individuals)."[59] Thus, personal liability can result when a director (or officer or key employee) of a nonprofit organization breaches the standards of fiduciary responsibility.[60]

One of the principal responsibilities of board members is to maintain financial accountability and effective oversight of the organization they serve. Board members are guardians of the organization's assets, and are expected to exercise due diligence to see that the organization is well managed and has a financial position that is as strong as is reasonable under the circumstances. Fiduciary duty requires board members of exempt organizations to be objective, unselfish, responsible, honest, trustworthy, and efficient. Board members, as stewards of the organization, should always act for its good and betterment, rather than for their personal benefit. They should exercise reasonable care in their decision-making, and not place the organization under unnecessary risk.

The distinction as to legal liability between the board as a group and the board members as individuals relates to the responsibility of the *board* for the organization's affairs and the responsibility of *individual board members* for their actions personally. The board collectively is responsible and may be liable for what transpires within and happens to the organization. As the ultimate authority, the board should ensure that the organization is operating in compliance with the law and its governing instruments. If legal action ensues, it is often traceable to an inattentive, passive, and/or captive board. Legislators and government regulators are becoming more aggressive in demanding higher levels of involvement by and accountability of board members of tax-exempt organizations; this is causing a dramatic shift in thinking about board functions, away from the concept of mere oversight and toward the precept that board members should be far more involved in policy-setting and review, employee supervision, and overall management. Consequently, many boards of exempt organizations are becoming more vigilant and active in implementing and maintaining sound policies.

In turn, the board's shared legal responsibilities depend on the actions of individuals. Each board member is liable for his or her acts (commissions and omissions), including those that may be civil law or even criminal law offenses. In practice, this requires board members to hold each other accountable for deeds that prove harmful to the organization.

The board of a tax-exempt organization is collectively responsible for developing and advancing the organization's mission; maintaining the organization's tax-exempt status and (if applicable) its ability to attract charitable contributions; protecting the organization's resources; formulating the organization's budget; hiring and evaluating the chief executive; generally overseeing the organization's management; and supporting the fundraising that the organization undertakes.[61]

59. Joint Committee on Taxation, "Description of Present Law Relating to Charitable and Other Exempt Organizations and Statistical Information Regarding Growth and Oversight of the Tax-Exempt Sector" 17 (JCX-44-04), 108th Cong., 2d Sess. (June 22, 2004).
60. See § 5.4.
61. In general, Hopkins, *Legal Responsibilities of Nonprofit Boards* (Washington, D.C.: BoardSource, 2008); Goldschmid, "The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms," 23 *J. Corp. L.* 631 (Summer 1998).

§1.5 DUTIES OF DIRECTORS

The duties of the board of directors of a tax-exempt organization essentially are the duty of care, the duty of loyalty, and the duty of obedience. Defined by case law, these are the legal standards against which all actions taken or not taken by directors are measured. They are collective duties adhering to the entire board; the mandate is active participation by all of the board members. Accountability can be demonstrated by showing the effective discharge of these duties.

(a) Duty of Care

The duty of care requires that directors of a tax-exempt organization be reasonably informed about the organization's activities, participate in decision-making, and act in good faith and with the care of an ordinarily prudent person in comparable circumstances. In short, the duty of care requires the board—and its members individually—to pay attention to the organization's activities and operations.

The duty of care is satisfied by attendance at meetings of the board and appropriate committees; advance preparation for board meetings, such as reviewing reports and the agenda prior to meetings of the board; obtaining information, before voting, to make appropriate decisions; use of independent judgment; periodic examination of the credentials and performance of those who serve the organization; frequent review of the organization's finances and financial policies; and compliance with filing requirements, particularly annual information returns.

(b) Duty of Loyalty

The duty of loyalty requires board members to exercise their power in the interest of the tax-exempt organization and not in their personal interest or the interest of another entity, particularly one with which they have a formal relationship. When acting on behalf of the exempt organization, board members are expected to place the interests of the organization before their personal and professional interests.

The duty of loyalty is satisfied when board members disclose any conflicts of interest; otherwise adhere to the organization's conflict-of-interest policy; avoid the use of corporate opportunities for the individual's personal gain or other benefit; and do not disclose confidential information concerning the information.

Conflicts of interest are not inherently illegal. Indeed, they can be common, because board members are often simultaneously affiliated with several entities, both for-profit and nonprofit. The important factor is the process by which the board copes with these conflicts. A conflict-of-interest policy can help protect the organization and its board members by establishing a procedure for disclosure and voting when situations arise where a board member may potentially derive personal or potential benefit from the organization's activities.

(c) Duty of Obedience

The duty of obedience requires that directors of a tax-exempt organization comply with applicable federal, state, and local laws; adhere to the organization's governing documents; and remain guardians of the organization's mission. The duty of obedience is complied with when the board endeavors to be certain that the organization is

in compliance with applicable regulatory requirements, complies with and periodically reviews all documents governing the operations of the organization, and makes decisions in advancement of the organization's mission and within the scope of the entity's governing documents.[62]

§ 1.6 BOARD COMPOSITION AND FEDERAL TAX LAW

Generally, the federal statutory tax law, the federal tax regulations, or the rulings from the Internal Revenue Service (IRS) have little to say about the composition of the governing board of a nonprofit, tax-exempt organization; it is, as noted, essentially a state law matter.[63] Basically, then, as a matter of law,[64] those forming and operating a nonprofit organization are free to structure and populate its board in any manner they determine.

(a) Doctrine of Private Inurement

A federal tax law doctrine that is directly relevant to the matter of nonprofit governance is the doctrine of *private inurement*. The federal law of tax exemption for charitable and other exempt organizations requires that each of these entities be organized and operated so that "no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual." Literally, this means that the profits of an exempt organization may not be passed along to individuals or other persons in their private capacity. In fact, the private inurement proscription, as expanded and amplified by the IRS and the courts, today means much more.

The contemporary meaning of the thoroughly antiquated statutory private inurement provision is scarcely reflected in its literal form and transcends the nearly 100-year-old formulation. What the doctrine means is that none of the income or assets of a tax-exempt organization that is subject to the inurement rule (and most types are) may be permitted to directly or indirectly unduly benefit an individual or other person who has a close relationship with the organization, when he, she, or it is in a position to exercise a significant degree of control over it.

The essence of the private inurement concept is to ensure that a nonprofit organization, particularly a charitable one, is serving public, not private, interests. To be tax-exempt, a nonprofit organization must establish that it is not organized and operated for the benefit of private interests—designated individuals, the creator of the entity or his or her family, shareholders of the organization, persons controlled (directly or indirectly) by private interests, or any persons having a personal and private interest in the activities of the organization. For the private inurement doctrine to apply, the transaction or other arrangement must involve an *insider* with respect to the organization, such as its trustees, directors, officers, and key employees, and their family members and controlled entities.

62. In general, Sasso, "Searching for Trust in the Not-For-Profit Boardroom: Looking Beyond the Duty of Obedience to Ensure Accountability," 50 *U.C.L.A. L. Rev.* 1485 (August 2003); Cherry, "Update: The Current State of Nonprofit Director Liability," 37 *Duq. L. Rev.* 557 (Summer 1999); Sparks, III & Hamermesh, "Common Law Duties of Non-Director Corporate Officers," 48 *Bus. Law.* 715 (Nov. 1992).
63. There are four exceptions to this statement; they are the subject of § 5.3(a).
64. As opposed to the IRS's application of the law (see § 5.21(e), (f)).

Private inurement has a multitude of manifestations. For a transaction to entail private inurement, however, the economic benefit to the insider must be excessive or unreasonable; benefits to insiders that are reasonable are permissible. The most common form of private inurement is excessive compensation. Other private inurement transactions are rental arrangements, loans, and provision of certain services or certain uses of an organization's assets.

The sanction for violation of the private inurement doctrine is loss or denial of recognition of the organization's tax-exempt status. The general expectation is that the IRS will first apply the intermediate sanctions rules, invoking private inurement principles only in egregious cases. Nonetheless, it is possible for the IRS to apply both bodies of law, thus penalizing the insider or insiders who obtained the excess benefit and the tax-exempt organization that provided it.[65]

(b) Doctrine of Private Benefit

The private benefit doctrine is somewhat the same as the private inurement doctrine; indeed, nearly every transaction or arrangement that constitutes private inurement simultaneously amounts to private benefit. The principal dissimilarities between the two sets of rules are that application of the private benefit doctrine does not require the involvement of an insider and the private benefit doctrine tolerates insubstantial private benefit. Technically, the private benefit doctrine applies only with respect to exempt charitable entities. The sanction for violation of the private benefit doctrine also is loss or denial of recognition of tax-exempt status.

The private benefit doctrine, created largely by the courts, is more sweeping than the private inurement doctrine. In recent years, the private benefit doctrine has emerged as a potent force in the law concerning charitable organizations. Private benefit can occur, for example, in connection with various types of joint ventures. The IRS, from time to time, finds impermissible private benefit conferred by charitable entities on other types of tax-exempt organizations, such as social welfare organizations and associations.[66]

The IRS is applying the private benefit doctrine in an attempt to achieve certain objectives in the nonprofit governance setting. Although the doctrine is supposed to be applied as a sanction—that is, only when some form of unwarranted benefit actually occurs[67]—today's IRS asserts that the doctrine is applicable where, on the basis of revenue agents' speculation, private benefit *might* or *could* occur.[68]

(c) Board Composition and Courts

The courts have constructed certain presumptions in the private inurement and private benefit contexts. Particularly with respect to the private inurement doctrine, an arrangement involving insiders often gives rise to a higher scrutiny of the facts and potential for violation of the doctrine. For example, the U.S. Tax Court expressed the view that "where the creators [of an organization] control the affairs of the organization, there is an obvious opportunity for abuse, which necessitates an open and

65. The private inurement doctrine is the subject of Chapter 20 of *Law of Tax-Exempt Organizations*; the intermediate sanctions rules are summarized in *id*., Chapter 21.
66. The private benefit doctrine is the subject of *id*., § 20.11.
67. See § 1.6(c).
68. See § 5.21(e).

candid disclosure of all facts bearing upon the organization, operation, and finances so that the Court can be assured that by granting the claimed exemption it is not sanctioning an abuse of the revenue laws."[69] The court added that, where this disclosure is not made, the "logical inference is that the facts, if disclosed, would show that the [organization] fails to meet the requirements" for tax-exempt status.[70]

In another case, where all of the directors and officers of an organization were related, the Tax Court could not find the "necessary delineation" between the organization and these individuals acting in their personal and private capacity.[71] Earlier, a court of appeals concluded that the fact that a married couple comprised two of three members of an organization's board of directors required a special justification of certain payments by the organization to them.[72] Before that, an appellate court decided that an individual who had "complete and unfettered control" over an organization has a special burden to explain certain withdrawals from the organization's bank account.[73]

In still another setting, a court considered an organization with three directors, consisting of the founder, his wife, and their daughter; they were part of the membership base totaling five individuals. The small size of the organization was held to be "relevant," with the court finding private inurement and private benefit because of the "amount of control" the founder exercised over the organization's operations and the "blurring of the lines of demarcation between the activities and interests" of the organization.[74] The court observed, nonetheless, that "[t]his is not to say that an organization of such small dimensions cannot qualify for tax-exempt status."[75]

Private inurement was also the basis for revocation of the tax-exempt status of a private school.[76] The individual who was the founder, president, chief executive officer, and executive director of the school used the school's funds for personal purposes. There was no documentation of any loans to or repayments by this individual. The state where the school was located revoked the school's charter, in part because this individual had "unfettered discretion to direct and manage the operation" of the school and "its financial affairs."[77] The court wrote that factors "emerging repeatedly [in the law] as indicative of prohibited inurement and private benefit include control by the founder over the entity's funds, assets, and disbursement; use of entity moneys for personal expenses; payment of salary or rent to the founder without any accompanying evidence of analysis of the reasonableness of the amounts; and purported loans to the founder showing a ready private source of credit."[78]

69. United Libertarian Fellowship, Inc. v. Comm'r, 65 T.C.M. 2175, 2181 (1993).
70. *Id*. Identical phraseology was used by the court in a prior proceeding (Bubbling Well Church of Universal Love, Inc. v. Comm'r, 74 T.C. 531, 535 (1980), *aff'd*, 670 F.2d 104 (9th Cir. 1981)).
71. Levy Family Tribe Found., Inc. v. Comm'r, 69 T.C. 615, 619 (1978).
72. Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969), *cert. den.*, 397 U.S. 1009 (1970).
73. Parker v. Comm'r, 365 F.2d 792, 799 (8th Cir. 1966), *cert. den.*, 385 U.S. 1026 (1967).
74. Western Catholic Church v. Comm'r, 73 T.C. 196, 213 (1979).
75. *Id*. In Blake v. Comm'r, 29 T.C.M. 513 (1970), an organization of similar dimensions was ruled to be tax-exempt; private inurement and private benefit were not at issue in the case. In comparable circumstances, the IRS refused to grant recognition of exemption to an organization, although private inurement was not in evidence, because the agency suspected private inurement would occur in the future (Priv. Ltr. Rul. 200535029).
76. Rameses School of San Antonio, Texas v. Comm'r, 93 T.C.M. 1092 (2007).
77. *Id*. at 1093.
78. *Id*. at 1095.

(d) Board Composition and the IRS

Some in the IRS who process applications for recognition of tax exemption or otherwise review the operations of tax-exempt organizations are not well trained in the law of tax-exempt organizations. These individuals have a tendency to substitute their view as to what the law is (or should be) for the actual legal requirements and demand that the organizations do something (or refrain from doing something) as a condition of exemption. In this regard, they usually are in error. Nowhere is this regrettable phenomenon more prevalent than in the case of the composition of the board of tax-exempt organizations.

Following are positions of IRS reviewers that tax-exempt organizations, most likely charitable ones, and their representatives may encounter:

- *Public board.* The governing board of a tax-exempt organization must be reflective of the public. An IRS specialist asserted that "[u]nrelated individuals selected from the community you serve should control the non-profit." One applicant was directed to "expand your board at this time, so control no longer rests with related individuals." Another was told that the entity needs to enlarge its board "to remove the close control issue." Still another IRS specialist articulated the thought that the "structure [of the board] must be changed to allow members of the general public to control the non-profit organization."
- *Control by a for-profit organization.* An IRS specialist wrote: "No for-profit should have control of a non-profit organization."[79]
- *Conflicts.* An IRS specialist asserted that a majority of an exempt organization's board may not be related to salaried personnel or to parties providing services to the organization.
- *One director.* An IRS law specialist was of the view that a tax-exempt organization could not have only one director, state law notwithstanding. This fact was seen by the specialist as a violation of the doctrine of private inurement. The specialist wrote that this individual "stands in a relationship" with the organization, "which offers him the opportunity to make use of the organization's income or assets for personal gain."
- *Experience.* An IRS reviewer asked an organization for a statement as to the board members' "experience" in serving on the board of a nonprofit organization.
- *Participation.* An IRS law specialist demanded that an applicant organization produce a statement, signed by each director, that the directors will "take an active part" in the operations of the organization.
- *Intermediate sanctions.* An IRS law specialist tried to force an applicant organization to provide a statement, signed by each director, that they were aware of and would abide by the intermediate sanctions rules in their service to the organization.[80]

79. Were this the law, a for-profit corporation could not have a related private foundation.
80. To compound the foolishness, the applicant organization was a private operating foundation (see *Law of Tax-Exempt Organizations* § 12.1(b)), so the intermediate sanctions rules did not apply in the first instance.

These assertions as to the state of the law, practices, and required statements have an element in common: they are nonsense. None of this is the law; none of this is required. The lawyer or other representative of the organization should stand up to these IRS exempt organization law "specialists," explain to them (politely, of course) why they are flat wrong, make it abundantly clear that their demands are going to be disregarded, and state that if they persist with their position(s), the matter will be referred to the IRS National Office for resolution. They usually will back down, particularly in the face of an assertion that they are merely (and erroneously) inserting their personal views into the case. A problem in this regard arises when an applicant organization has made the filing without the services of a tax-exempt organizations professional, or is using the services of a professional who is not sufficiently proficient in this area of the law, and innocently believes that it must comply with the specialist's demand(s)—and does.

The IRS traditionally has been more measured on these points in its private letter rulings, relying more (as do the courts) on presumptions than absolute declarations. In one instance, the agency's lawyers wrote that when an organization is "totally controlled" by its founder and his or her immediate family, the entity "bears a very heavy burden to be forthcoming and explicit about its plans for the use of [its] assets" for charitable purposes, and warned that this structure lacks "institutional protections," that is, a board of directors consisting of "active, disinterested persons."[81] Thus, this rule was articulated: "Small, closely controlled exempt organizations—and especially those that are closely controlled by members of one family— . . . require thorough examination to [e]nsure that the arrangements serve charitable purposes rather than private interests."[82] The IRS's lawyers conceded, nonetheless, that "[t]here is nothing that precludes an organization that is closely controlled . . . from qualifying, or continuing to qualify, for exemption."[83]

Consequently, while there is nothing specific in the operational test[84] concerning the size or composition of the governing board of a charitable or other tax-exempt organization, the courts and the IRS have grafted onto the test a greater burden of proof standard when the organization has a small board of directors and/or is dominated by an individual.[85]

81. IRS Technical Advice Memorandum (Tech. Adv. Mem.) 200437040.
82. *Id*.
83. *Id*.
84. See *Law of Tax-Exempt Organizations* § 4.5(a).
85. In general, Gary, "Regulating Management of Charities: Trust Law, Corporate Law, and Tax Law," 21 *Haw. L. Rev.* 593 (Winter 1999).