PART ONE

Starting a Nonprofit Organization

CHAPTER ONE

What Is a Nonprofit Organization?

One of the most striking features of life as we settle into the third millennium is the awesome sweep of reform around the world. Freedom of thought and action is now permitted in societies that previously knew only totalitarianism and suppression. Frequently, a country earns the label *emerging democracy* by introducing startling economic and political changes. Sometimes, this is accomplished by elections; sometimes, a revolution is necessary. The collapse of the former U.S.S.R., along with the struggles toward freedom and economic betterment in the several countries that were once part of it, is a prime example of these reforms.

Countries that are planning transitions to a democratic state are discovering a fact that some Western countries learned a long time ago: To create and maintain economic and political freedom, which is the essence of a true democracy, the power to influence and cause changes cannot be concentrated in one sector of that state or society. There must be a *pluralization of institutions* in society, which is a fancy way of saying that the ability to bring about changes and the accumulation of power cannot belong to just one sector—namely, the government. A society that has achieved this type of pluralization is sometimes known as a *civil society*.

A strong democratic state has three sectors: a government sector, a private business sector, and a nonprofit sector. Each sector must function effectively and must cooperate with the others, to some degree, if the democracy is to persist for the good of the individuals in the society. A democratic society must be able to make and implement policy decisions with the participation of all three sectors. Ideally, a democratic society can solve some of its problems with minimal involvement of government if there is a well-developed and active nonprofit sector—charitable, educational, scientific, and religious organizations; associations and other membership organizations; advocacy groups; and similar private agencies.

Of all countries, the United States has the most highly developed sector of nonprofit organizations. The reach of the U.S. government is often curbed by the activities of nonprofit organizations, but that is a prime mark of a free and otherwise democratic society. The federal, state, and local governments acknowledge this fact (sometimes grudgingly) by exempting most nonprofit organizations from income and other taxes and, in some instances, allowing tax-deductible gifts to them. These tax enhancements are crucial for the survival of many nonprofit organizations.

When an individual in the United States perceives either a personal problem or one involving society, he or she does not always have to turn to a government for the

problem's resolution. The individual, acting individually or with a group, can attempt to remedy the problem by turning to a nongovernmental body. There are obvious exceptions to this sweeping statement: Governments provide a wide range of services that individuals cannot, such as national defense and foreign policy implementations. Still, in U.S. culture, more so than in any other, an individual is often likely to use nongovernmental means to remedy, or at least address, personal and social problems.

A BIT OF PHILOSOPHY

For most Americans, this mind-set stems from the very essence of our political history—distrust of government. We really do not like governmental controls; we prefer to act freely, as individuals, to the extent it is realistic and practical to do so. As the perceptive political philosopher Alexis de Tocqueville wrote in 1835, ''Americans of all ages, all conditions, and all dispositions constantly form associations'' (meaning nonprofit organizations) and ''[w]henever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association.'' About 150 years later, John W. Gardner, founder of Common Cause, observed: ''In the realm of good works this nation boasts a unique blending of private and governmental effort. There is almost no area of educational, scientific, charitable, or religious activity in which we have not built an effective network of private institutions.''

This ''effective network of private institutions'' (the nation's nonprofit organizations) is called the *independent sector*, the *voluntary sector*, or the *third sector* of U.S. society. For-profit organizations are the business sector; the governmental sector is made up of the branches, departments, agencies, and bureaus of the federal, state, and local governments.

Nonprofit organizations, particularly charitable ones, foster pluralization of institutions and encourage voluntarism. Society benefits not only from the application of private wealth to specific public purposes but also from the variety of programs that individual philanthropists, making gifts of all sizes, make available for support. Program choice–making is decentralized, efficient, and more responsive to public needs than the cumbersome and less flexible government allocation process. As John Stuart Mill once observed, ''Government operations tend to be everywhere alike. With individuals and voluntary associations, on the contrary, there are varied experiments, and endless diversity of experience.''

Contemporary writing is replete with statements of these fundamental principles. Here are some examples:

> . . . the associative impulse is strong in American life; no other civilization can show as many secret fraternal orders, businessmen's ''service clubs,'' trade and occupational associations, social clubs, garden clubs, women's clubs, church clubs, theater groups, political and reform associations, veterans' groups, ethnic societies, and other clusterings of trivial or substantial importance.—*Max Lerner*

> . . . in America, even in modern times, communities existed before governments were here to care for public needs.—*Daniel J. Boorstein*

> . . . voluntary association with others in common causes has been thought to be strikingly characteristic of American life.—*Merle Curti*

> We have been unique because another sector, clearly distinct from the other two [business and government], has, in the past, borne a heavy load of public responsibility.—*Richard C. Cornuelle*
>
> The third sector is . . . the seedbed for organized efforts to deal with social problems.—*John D. Rockefeller*
>
> . . . the ultimate contribution of the Third Sector to our national life—namely, what it does to ensure the continuing responsiveness, creativity and self-renewal of our democratic society.—*Waldemar A. Neilsen*
>
> . . . an array of its [the independent sector's] virtues that is by now fairly familiar: its contributions to pluralism and diversity, its tendency to enable individuals to participate in civic life in ways that make sense to them and help to combat that corrosive feeling of powerlessness that is among the dread social diseases of our era, its encouragement of innovation and its capacity to act as a check on the inadequacies of government.—*Richard W. Lyman*
>
> The problems of contemporary society are more complex, the solutions more involved and the satisfactions more obscure, but the basic ingredients are still the caring and the resolve to make things better.—*Brian O'Connell*

NONPROFIT ORGANIZATIONS AND LAW

The English language does not serve us well in this context, in that the term *nonprofit organization* is often misunderstood. This term does not refer to an organization that that is prohibited by law from earning a *profit* (that is, an excess of gross earnings over expenses); *nonprofit* does not mean *no profit*. In fact, it is quite common for nonprofit organizations to generate profits. (Those make the better clients.) Rather, the definition of nonprofit organization essentially relates to requirements as to what must be done with the profit earned or otherwise received. This fundamental element of the law is found in the doctrine of *private inurement* (see Chapter 5).

The word *nonprofit*, by the way, should not be confused with the term *not-for-profit* (although it often is). (For inexplicable reasons, the accounting profession prefers the phrase *not-for-profit*.) The former describes a type of organization; the latter describes a type of activity. For example, in the federal income tax setting, expenses associated with a not-for-profit activity (namely, one conducted without the requisite profit motive, as in the nature of a hobby) are not deductible as business expenses.

The concept in law of a nonprofit organization is best understood through a comparison with the concept of a *for-profit* organization. A fundamental distinction between the two types of entities is that the for-profit organization has *owners* that hold the equity in the enterprise, such as stockholders of a corporation. The for-profit organization is operated for the economic benefit of its owners; the profits of the business undertaking are passed through to them, such as by the payment of dividends on shares of stock. That is what is meant by the term for-profit organization: It is an entity that is designed to generate a profit for its owners. The transfer of the profits from the organization to its owners is pure private inurement—the inurement of net earnings to them in their private (personal) capacity. For-profit organizations are *supposed* to engage in private inurement.

By contrast, a nonprofit organization is not permitted to distribute its profits (net earnings) to those who *control* it, such as directors and officers. Normally, a nonprofit entity does not have *owners*; a few states allow nonprofit corporations to issue non–dividend paying stock. The U.S. Supreme Court has contemplated this point only once, writing that a ''nonprofit entity is ordinarily understood to differ from a for-profit corporation principally because it is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.''

Simply stated, a nonprofit organization is an entity that is not permitted to engage in forms of private inurement. This is why the private inurement doctrine is the substantive defining characteristic that distinguishes nonprofit organizations from for-profit organizations for purposes of the law. To reiterate: Both nonprofit and for-profit organizations are legally able to generate a profit. Yet, as the comparison between the two types of organizations indicates, there are two categories of profit: one is at the *entity* level and one is at the *ownership* level. Both categories of entities can yield entity-level profit; the distinction between the two types of entities pivots on the latter category of profit.

Why, then, the confusion as to the meaning in law of the term *nonprofit organization*? The answer: For-profit and nonprofit organizations often *look alike*. (This fact is behind, for example, today's raging debates about the difference between tax-exempt and for-profit hospitals and exempt credit unions and commercial banks.) The characteristics of the two categories of organizations are often identical, in that both mandate a legal form (see discussion following), have directors (or trustees) and officers, have employees (and thus pay compensation and other employee benefits), face essentially the same expenses (such as for occupancy, supplies, travel, and, yes, legal and other professional fees), make investments, enter into contracts, can sue or be sued, produce goods and/or services, and (as noted) generate profits.

LEGAL FORM

What form should a prospective nonprofit organization take? A lawyer may say, ''It must be a separate legal entity.'' What does that mean?

A nonprofit organization generally must be one of three types: a corporation: a trust, or an ''other'' (usually an unincorporated association). In recent years the *limited liability company* has emerged as a possible form. (Occasionally, a nonprofit organization is created by a legislature.) A common element in each is that there should be a creating document (*articles of organization*) and a document containing operational rules (*bylaws*).

Keep in mind that before an organization can be tax-exempt, it must be a nonprofit organization. Nonprofit organizations are basically creatures of state law; tax-exempt organizations are basically subjects of federal tax law. State tax exemption tends to follow the contours of the federal tax law (although the real estate tax exemption rules are likely to be more stringent).

Once the decision has been made to form a nonprofit organization, the legal form of the organization must be considered. This is basically a matter of state law; the laws of the state in which the headquarters is based will govern this decision.

Assuming that the nonprofit organization is expected to qualify as a tax-exempt organization under both federal and state law, it is essential to see whether a particular form of organization is dictated by federal tax law. In most cases, federal law is neutral

on the point. In a few instances, however, a specific form of organization is required to qualify as a tax-exempt organization. For example, a federal government instrumentality and a title-holding organization must, under federal tax law, be formed as corporations, while entities such as supplemental unemployment benefit organizations, Black Lung benefit organizations, and multiemployer plan funds must be formed as trusts. A multibeneficiary title-holding organization can be formed as either a corporation or a trust. On occasion, a federal law other than the tax law will have a direct bearing on the campaign regulation laws; corporations cannot make political campaign contributions. A political committee may have to avoid the corporate form.

These are relatively technical types of nonprofit organizations; the vast majority need not be created by a mandated form. Thus, in the absence of a federal (or state) law requiring a particular form for the organization, the choice is made by those who are establishing the entity.

There are several factors to take into account in selecting the form of a nonprofit organization. Given the reality of our litigious society, personal liability looms as a major element in the decision. *Personal liability* means that one or more managers of a nonprofit organization (its trustees, directors, officers, and/or key employees) may be found *personally* liable for something done or not done while acting on behalf of the organization. (See Chapter 25.)

THE FOUR I'S

Some of this exposure to personal liability can be limited by one or all of the following: indemnification, insurance, immunity, and incorporation.

Indemnification occurs (assuming indemnification is legal under applicable state law) when the organization agrees (usually by provision in its bylaws) to pay the judgments and related expenses (including legal fees) incurred by those who are covered by the indemnity, when those expenses are the result of a misdeed (commission or omission) by those persons while acting in the service of the organization. The indemnification cannot extend to criminal acts and may not cover certain willful acts that violate civil law. Because an indemnification involves the resources of the organization, the real value of an indemnification depends on the economic viability of the organization. In times of financial difficulties for a nonprofit organization, an indemnification of its directors and officers can be a classic ''hollow promise.''

Insurance is similar to indemnification. Instead of shifting the risk of liability from the individuals involved to the nonprofit organization, however, the risk of liability is shifted to an independent third party—an insurance company. Certain risks, such as criminal law liability, cannot be shifted via insurance. The insurance contract will likely exclude from coverage certain forms of civil law liability, such as libel and slander, employment discrimination, and antitrust matters. Even where adequate coverage is available, insurance can be costly; premiums can easily amount to thousands of dollars annually, even with a sizeable deductible.

Immunity is available when state law provides that a class of individuals, under certain circumstances, is not liable for a particular act or set of acts or for failure to undertake a particular act or set of acts. Several states have enacted laws for officers and directors of nonprofit organizations, protecting them in case of asserted civil law violations, particularly where these individuals are functioning as volunteers.

Incorporation is the last of the four I's. This additional form of protection against personal liability is discussed next, as part of the summary of the type of legal entity known as the *corporation*.

THE CORPORATION

A *corporation* is regarded as a separate legal entity. Liability is generally confined to the organization and does not normally extend to those who manage it. For this reason alone, a nonprofit organization should probably be incorporated.

Incorporation has another advantage. The state nonprofit corporation law may provide answers to many of the questions that inevitably arise when forming and operating a nonprofit organization. Here are some examples:

- How many directors must the organization have? What are their voting rights? How is a quorum ascertained? How is notice properly given? What is the length and number of their terms of office?
- What officers must the organization have? What are their duties? What is the length and number of their terms of office? Can more than one office be held by the same individual?
- 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 unanimous consent? Can they use proxies?
- If there are members, what are their rights? When must they meet? What notice of the meetings must be given? How can they vote?
- 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, including an advisory committee? Which are standing committees?
- How are the organization's governing instruments amended?
- How must a merger of the organization occur?
- What is the process for dissolving the organization? For distributing its assets and net income on dissolution?

Nearly every state has a nonprofit corporation act. The answers to these and many other questions may be found in that law. If the organization is not a corporation, these and other questions are usually unanswered under state law. The organization must then add to its rules the answers to all the pertinent questions (assuming they can be anticipated) or live with the uncertainties.

There is a third reason for the corporate form: More people will know what the entity is. People are familiar with corporations. The IRS knows corporations. Private foundations understand corporations as potential grantees. In general, the work in which the nonprofit organization will be functioning is compatible with the concept of a corporation.

In contrast to the three advantages of incorporation—limitation against personal liability, availability of information concerning operations, and the comfort factor—what are the disadvantages of incorporation? Generally, the advantages far outweigh the disadvantages. The disadvantages stem from the fact that incorporation entails an affirmative act on the part of the state government: It ''charters'' the entity. 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 operation, an initial filing fee, annual reports (which are public documents), and annual fees. These costs are frequently nominal, however, and the reporting and disclosure requirements are usually not extensive.

A nonprofit organization that is a corporation is formed by preparing and filing *articles of incorporation*, with its operating rules embodied in *bylaws*. The contents of the articles of incorporation, dictated in part by state law, will usually include

- The name of the organization
- A general statement of its purposes
- 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)
- Language referencing the applicable federal tax law requirements

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

- Its purposes (it is a good idea to restate them in the bylaws)
- The election 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, quorum, and voting
- The role of excessive and other committees
- The role of its chapters (if any)
- The function of affiliated organizations (if any)
- The organization's fiscal year
- Language referencing the applicable federal tax law requirements (again, a good idea to repeat this in the bylaws)

Some organizations adopt operational rules and policies stated in a document that is neither articles of incorporation nor bylaws. These rules may be more freely amended than articles or bylaws. They should not, however, be inconsistent with the articles or bylaws.

THE TRUST

A nonprofit organization may be formed as a *trust*. This is rarely an appropriate form for a nonprofit organization other than a charitable entity or some of the funds

associated with employee plans. Many private foundations, for example, are trusts. Those created by a will are known as testamentary trusts.

Most nonprofit organizations, however, particularly those that will have a membership, are ill-suited to be structured as trusts.

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, and frequently impose fiduciary standards and practices that are more stringent than those for nonprofit corporations.

A nonprofit organization that is to be a trust is formed by the execution of a *trust agreement* or a *declaration of trust*. Frequently, only one trustee is necessary—another reflection of the usual narrow use of trusts.

The trustees of a trust do not have the protection against personal liability that is afforded by the corporate form.

Although a fee to the state is rarely imposed upon the creation of a trust, most states impose on trusts an annual filing requirement for the trust agreement or declaration of trust.

It is unusual—although certainly permissible—for the trustee(s) of a trust to adopt a set of bylaws.

THE UNINCORPORATED ASSOCIATION

The final type of the usual nonprofit organization is the *unincorporated association*.

To the uninitiated, a nonprofit corporation and a nonprofit unincorporated organization look alike. For example, a membership association has the same characteristics, whether or not it is incorporated. The shield against individual liability provided by the corporate form, however, is unavailable in an unincorporated association.

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

It is relatively uncommon for an unincorporated association to have to register with and annually report to a state (other than for fundraising regulation purposes; see Chapter 12).

Occasionally, nonprofit organizations will have articles of incorporation, a constitution, and bylaws. This is technically improper. For an incorporated nonprofit organization, the constitution is a redundancy.

Trusts and unincorporated associations are likely to have less contact with the state than nonprofit corporations, but this advantage is usually overshadowed by more substantive disadvantages.

In some states (e.g., California and New York), the nonprofit corporation and trust law is far more refined. Careful examination of these and other relevant laws is essential when an organization is to be formed in, or to operate in, one or more of these states. In addition, some states have far more stringent laws concerning mergers and dissolutions.

In summary, as a general rule a nonprofit organization has clear advantages if it is organized as a corporation. Nonetheless, the facts and circumstances of each

situation must be carefully examined to be certain that the most appropriate form is selected.

LOCATION

The starting point for organizing a nonprofit organization is the law of the state. But which state? Although it can operate in more than one jurisdiction, an organization can be created or formed under the law of only one jurisdiction (at a time). In most instances, this means selecting the jurisdiction in which the organization will be headquartered.

Because the process of qualifying an organization to do business in a state is about the same as incorporating it, there usually is no point in forcing the organization to comply with the laws of two states. There are exceptions to this rule: A stock-based nonprofit organization may be appropriate, or perhaps only one director is desired. Another consideration is the degree of regulation imposed by the office of a state's attorney general or comparable agency; this element varies widely from state to state. If an organization is formed in one state but has offices in one or more other states, this duplication of effort is unavoidable.

A caution: If a nonprofit organization is formed in one jurisdiction and the plan is to qualify it in another, be certain that the organization will meet the requirements of the law of the state of qualification. For example, not all states allow a nonprofit organization formed as a corporation with stock to qualify.

Checklist

- ❑ Form of organization:
  - ❑ Corporation
  - ❑ Unincorporated association
  - ❑ Trust
  - ❑ Other
- ❑ Type of articles of organization:
  - ❑ Articles of Incorporation
  - ❑ Constitution
  - ❑ Declaration of trust
  - ❑ Trust agreement
  - ❑ Other
- ❑ Date organization formed _____
- ❑ Place organization formed _____
- ❑ States in which qualified to do business _____
- ❑ Date(s) of amendment of articles _____
- ❑ Date operational rules (e.g., bylaws) adopted _____
- ❑ Date(s) of amendment of rules _____

❑ Membership: Yes _____ No _____

❑ If yes:

Annual meeting date _____

Notice requirement _____

❑ Chapters: Yes _____ No _____

❑ Affiliated organizations _____

❑ Committees: _____

- ❑ Executive
- ❑ Nominating
- ❑ Development (fundraising)
- ❑ Finance and/or Audit
- ❑ Long-Range Planning
- ❑ Other(s)

❑ Fiscal year _____