CHAPTER 1

General Operations of a Nonprofit Organization

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A lawyer representing nonprofit organizations faces, on a daily basis, a barrage of questions about the rules governing the organizations' formation, administration, operation, and management. Some of these questions may be answered using state law rules, some with federal law rules. More frequently than nonlawyers might suspect, there is no law on the particular point.

These questions may require answers from an accountant, a fundraiser, an appraiser, or a management consultant, rather than a lawyer. For example, a lawyer is not professionally competent to answer these questions: "How much can I be paid?" or "How much is this gift property worth?" Even regarding matters that are within the lawyer's province, however—legal standards—the law is often very vague. Much of the applicable law is at the state level, so there can be varied answers to questions. Yet federal law on the subject is building.

Here are the questions most frequently asked about general operations of a nonprofit organization—and the answers to them.

Q 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 costs) 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 profits 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* (see Chapter 6). That is, private inurement refers to ways of transferring an organization's net earnings to persons 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.

Q 1:2 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 exceptions: a few states allow nonprofit corporations to be established with the authority to issue stock.

NOTE: This type of stock does not pay dividends, because that would contravene the prohibition on private inurement (see Q 1:1). The stock can be transferred to others, however, by sale, gift, or otherwise.

Stock in a nonprofit organization is used solely for purposes of ownership. Any *person* (an individual, a business entity, or another nonprofit organization) can be a shareholder under this arrangement.

TIP: When a nonprofit organization is being established and those forming it want to ensure their control of it, irrespective of the composition of the board of directors, setting up a stock-based nonprofit organization often is the answer (see Q 1:23).

Q 1:3 Who controls a nonprofit organization?

It depends on the nature of the organization. Usually, control of a 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, such as a coalition, control may well be with the membership.

Q 1:4 Sometimes the term *not-for-profit organization* is used instead of *nonprofit organization*. Are the terms synonymous?

As a matter of law, no. 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 (Q 1:1).

Q 1:5 How is a nonprofit organization started?

Nearly every nonprofit organization is a creature of state law (or District of Columbia law). (A few nonprofit organizations are chartered under a federal statute.) 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 called articles of incorporation. For an unincorporated association, the articles are in the form of a constitution. The articles of a trust are called a trust agreement or a 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. An entity 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 (Chapter 13).

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.

Q 1:6 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 sign the articles.

TIP: This is not entirely a matter of state law. What is in or not in a set of articles of organization (Q 1:5) 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 purpose and, in the case of charitable entities, the inclusion of a clause preserving income and assets for charitable purposes.

Q 1:7 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 the 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 organization as being of great 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.

Q 1:8 Can the same individuals be the directors, officers, and incorporators?

Generally, yes. Again, the law of the appropriate state should be reviewed.

Q 1:9 What about the 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.

Q 1:10 What does the registered agent do?

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 authorities want to communicate with the corporation, they do so by contacting the agent. If someone wants to sue the corporation, the agent is served with the papers.

Q 1:11 Does the registered agent have any liability for the corporation's affairs?

No. 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.

Q 1:12 Can the same individual be a director, officer, incorporator, and registered agent?

Yes, unless state law expressly forbids such a multirole status, which is unlikely. The registered agent—if an individual—must be a resident of the state in which the entity is functioning (Q 1:9), but the requirement of residency is not applicable to the other roles.

Q 1:13 How does a nonprofit organization decide the state in which to be formed?

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.

Occasionally, however, another state's law contains attributes that are desirable for those who are forming a nonprofit organization. For example, only a few states permit the creation of a nonprofit corporation that can issue stock. An organization seeking this feature can be formed in one of those states and then qualified to conduct its activities in the state where its principal operations will be (Q 1:23).

TIP: 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.

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

Q 1:14 How does a nonprofit organization qualify to do business in another state?

A nonprofit organization qualifies to do business in another state by filing for 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).

TIP: The law of each state should be checked to see what persons qualify to be registered agents (Q 1:9). 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.

Q 1:15 What is the legal standard by which a nonprofit organization should be operated?

It depends on the type of organization. If the nonprofit organization is not tax-exempt, the standard is nearly the same as that for a for-profit entity. If the nonprofit organization is tax-exempt, but is not a charitable organization, the standard is higher. The legal standard is highest for a tax-exempt charitable organization. In general, the standard is easy to articulate, but often difficult to implement.

Q 1:16 What is the standard for an organization that is tax-exempt and charitable?

The legal standard by which all aspects of operations of the organization should be tested requires *reasonableness* and *prudence*. Everything the organization does should be undertaken in a reasonable manner and to a reasonable end. Also, those working for or otherwise serving the charitable organization should act in a way that is *prudent*.

The federal tax exemption granted to charitable and certain other forms of tax-exempt organizations can be revoked if the organization makes an expenditure or engages in some other activity that is deemed to be not reasonable. The same is likely true at the state level: unreasonable behavior may cause the attorney general to investigate the organization.

Q 1:17 What is the rationale for this standard for charities?

The principles underlying the laws concerning charitable organizations, both federal and state, are taken from English common law, principally those portions pertaining to trusts and property. The standards formulated by English law hundreds of

years ago for the administration of charitable trusts were very sound and very effective, and they underpin the laws today. The heart of these standards is the *fiduciary* relationship.

Q 1:18 What does the term *fiduciary* mean?

A *fiduciary* is a person who has special responsibilities in connection with the administration, investment, and distribution of property, where the property belongs to someone else. This range of duties is termed *fiduciary responsibility*. For example, guardians, executors, receivers, and the like are fiduciaries. Trustees of charitable trusts are fiduciaries. Today, a director or officer of a charitable organization is a fiduciary.

Indeed, the law can make anyone a fiduciary. As an illustration of the broad reach of this term, in a few states, professional fundraisers are deemed, by statute, fiduciaries of the charitable gifts raised during the campaigns in which they are involved.

Q 1:19 What is the standard underlying fiduciary responsibility?

In a word, *prudence*; a fiduciary is expected to act, with respect to the income and assets involved, in a way that is *prudent*. This standard of behavior is known as the *prudent person rule*. This rule means that fiduciaries are charged with acting with the same degree of judgment—prudence—in administering the affairs of the organization as they would in their personal affairs. Originally devised to apply in the context of investments, this rule today applies to all categories of behavior—both commissions and omissions—undertaken in relation to the organization being served.

Q 1:20 What is the meaning of the term *reasonable*?

The word *reasonable* is much more difficult to define than *prudence*. A judge, attorney general, IRS agent, and the like will say that the word is applied on a case-by-case basis. In other words, the term describes one of those things that one "knows when one sees it," much like obscenity.

The term *reasonable* is basically synonymous with *rational*. A faculty of the mind enables individuals to distinguish truth from falsehood and good from evil by deducing inferences from facts. Other words that can often be substituted for reasonable are *appropriate, proper, suitable, equitable*, and *moderate*. Whatever term is used, an individual in this setting is expected to use this faculty and act in an appropriate and rational manner.

Q 1:21 Who are the fiduciaries of a charitable organization?

The principal fiduciaries of a charitable organization are the directors. The officers are also fiduciaries. Other fiduciaries may include an employee who has responsibilities similar to those of an officer, such as a chief executive officer or a chief financial officer who is not officially a director or officer. Outsiders, such as people who are hired to administer an endowment fund or pension plan, are fiduciaries with re-

spect to the organization. Each of these individuals has what is known as *fiduciary responsibility* (Q 1:19).

Q 1:22 What happens as the nonprofit organization grows, achieves a higher profile, and needs to add individuals to the board? How do those who created the entity retain control of the organization? After all their hard work, they definitely don't want some other group to run off with the organization.

That is certainly true. This is a very common problem. An illustration is an organization that provides scholarships. Over time, the gift support and scholarships increase, as does the number of benefited students and grateful family members. More people will take interest in the organization. Some donors may ask whether they can join the board. Others will encourage the original board members to add individuals to the board who are professional educators and can bring expertise to the organization. Some private foundations interested in making grants may want the organization's board to be more reflective of the community.

Suppose, for example, that there are four educators in the community who are very suitable for inclusion on the board—and they are willing to serve. The three founders freely acknowledge they could use the help. But, with a board of seven, the original three would probably lose control. The educators could vote the three out of their directors' seats and out of their offices. After all of their hard work and success, the founders of the organization could be completely excluded from its operations.

The three existing board members have understandable worries.

Q 1:23 Can the founding board have it both ways? Can it retain control of the organization and, at the same time, have an expanded and more professional governing board?

Yes. There are four ways to do this.

1. Be certain that the other board members are friends and other colleagues who will not subsequently attempt to wrest control of the organization away from the founders. This approach works only to the extent the loyalty remains.
2. Have two classes of members, with the founders in one class and all other board members in the other. The governing documents then provide that certain decisions can be made only after a majority vote of both classes.
3. Use the membership feature. The founding individuals become members of the organization. The governing documents then provide that certain decisions can be made only by the members and/or that all board members can be removed by the members.
4. Issue stock, if permitted. In a few states, nonprofit organizations can be created with the authority to issue stock. The controlling individuals become stockholders. The governing documents then provide that certain decisions

are reserved to the stockholders and/or that all board members can be removed by the stockholders.

TIP: Before any of these approaches is utilized in a particular case, the law of the appropriate state(s) should be examined to be certain it is permissible.

Q 1:24 What are the rules regarding the development of chapters?

There is very little law on this topic. A nonprofit organization that wants to have chapters is free to do so. The principal legal question for an organization with chapters is whether the chapters are separate legal entities or are part of the "parent" organization.

Thus, the rules as to chapters are likely to be confined to those the principal organization devises. A good practice for the main organization is to develop criteria for the chapters and then "charter" them according to the criteria. Some parent organizations execute a contract with their chapters, to be in a position to enforce the criteria. To some extent, then, the proper process for the creation and maintenance of a chapter program is akin to franchising in the for-profit setting.

There are no rules—other than those that an organization devises for itself—regarding the jurisdiction of chapters. A chapter can encompass a state, a segment of a state, or several states. There is no legal need for uniformity on this point; chapters can be allocated on the basis of population.

Q 1:25 Do chapters have to be incorporated?

No, there is no legal requirement that chapters be incorporated. (Basically, there is little law mandating that any nonprofit organization be incorporated.) It is a good practice to cause the chapters to be corporations, however, so as to minimize the likelihood of liability for the parent organization and the boards of directors of the chapters.

Again, this pertains to the question of whether the chapters are separate legal entities (Q 1:24). A chapter can be a separate legal entity without being incorporated; for example, a chapter can be an unincorporated association. (It is not likely that the chapter would be in trust form (Q 1:5).) In most instances, chapters are separate legal entities. This means, among other elements, that they must have their own identification number (they should not use the parent organization's number) and pursue their own tax exemption determination letter (unless they are going to rely on the group exemption).

Q 1:26 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

tasks are: to know the law (and avoid malpractice), 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.

The typical lawyer today is a specialist, and the nonprofit lawyer is no exception. Nonprofit law is unique and complex; the lawyer who dabbles in it does so at peril. A lawyer may be the best of experts on labor or securities law, and know nothing about nonprofit law. The reverse is, of course, also true: the nonprofit lawyer is likely to know nothing about admiralty or domestic relations law.

The first task listed above 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 to 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 environmental 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. This is particularly the case with trade, business, and professional organizations. 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.

Q 1:27 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 a hourly rate for the time expended. In these circumstances, the client is entitled to a statement (usually monthly) that clearly reflects the time expended, how it was expended, who expended it (including paralegals), and the hourly rates. These statements usually itemize expenses to be reimbursed.

It is 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. The 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 (Q 1:16).