

P A R T
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**AN OVERVIEW OF NONPROFITS'
LEGAL NEEDS**

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CHAPTER 1

What Good Counsel Can Do for Nonprofits

This chapter surveys the broad landscape of nonprofit organizations, clarifying often-confusing terminology and pinpointing what differentiates nonprofits from for-profits (hint: it's not whether or not the entity makes a profit). The chapter then introduces the main legal concerns that set nonprofits apart from other kinds of business entities. Different from most other books about nonprofit law, it goes on to describe other kinds of business laws that apply to all entities—whether nonprofit or for-profit—much to the surprise of many nonprofit executives, who may have the erroneous impression that their organizations are not only tax exempt but law exempt! The wide array of laws applicable to nonprofits, the similarities and differences between how business laws apply to nonprofits and other kinds of business entities, and how compliance with applicable laws can help the organization make good on its mission, are recurring themes throughout the book.

Board members, management and incoming counsel may benefit from reading together the three chapters in Part I.

Because of the broad sweep of the nonprofit sector, generalizations about legal needs are hard to make. The sector encompasses large institutions and smaller ones; some that predate the founding of our nation and some that are still in the process of being formed; some that attract nationwide attention and others that labor in relative anonymity; some with an international footprint and some that operate out of the founder's living room.

What Legal Needs Do Nonprofits Have in Common?

The primary focus of this book, and the largest category of nonprofit organizations, is the million or so public charities that are tax exempt under Section 501(c)(3) of the United States Internal Revenue Code. These organizations include hospitals, museums, private schools, religious congregations, orchestras, public television and radio stations, soup kitchens, and certain types of foundations, such as organizations that prevent cruelty to children or animals or foster a cleaner environment. (Although private foundations and some other types of nonprofit organizations under Section 501(c) of the Internal Revenue Code face legal issues that are similar in many respects to public charities, there are enough differences that it would not be practical to identify each one in this book.) For convenience, this book will use the term nonprofit organizations, or nonprofits, to refer to Section 501(c)(3) public charities.¹

Other kinds of nonprofit organizations, such as chambers of commerce, fraternal organizations, or civic and athletic leagues, may be tax exempt, but contributions to them are not tax-deductible.

Figure 1.1 may help readers visualize these various categories.

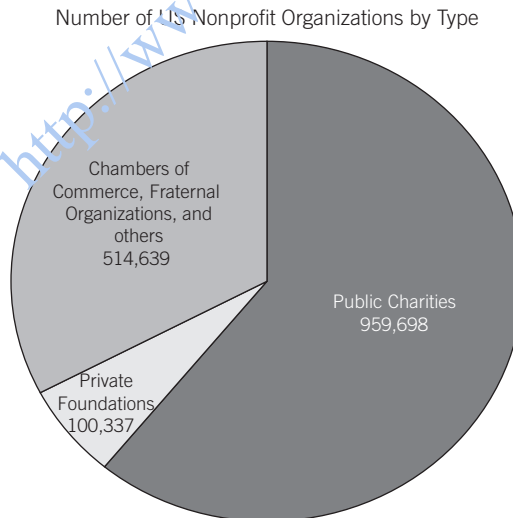


Figure 1.1 Number of U.S. Nonprofit Organizations by Type

Source: National Center for Nonprofit Statistics Business Master File, August 2011.

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This volume is aimed at Section 501(c)(3) organizations that qualify as public charities.

Confusion abounds regarding terminology. Tax-exempt organizations, nonprofit organizations, and not-for-profits are often used interchangeably but, technically speaking, these terms have different meanings. The term tax-exempt organization refers to organizations that are exempted from certain kinds of taxes by the federal, state, and local governments. The term nonprofit organization is broader, and may refer to all kinds of entities that exist not to make profits for owners but for a broader purpose. State laws, under which nonprofits are organized, generally prohibit the organizations from making distributions to their founders or insiders, or otherwise operating primarily for the financial benefit of any private party. Instead of paying dividends to shareholders or creating other economic value for private persons, nonprofit organizations plow the net proceeds (that is, profits) from their operations back into their mission-related activities, in furtherance of their stated public purpose.

Different states use different terminology—some use nonprofit, some use not-for-profit, and others use other terminology and different criteria for organizations to qualify as nonprofit corporations. Further confusing matters, experts in the field often use the word charity to refer to all kinds of 501(c)(3) organizations, including organizations with scientific research, culture, or the advancement of religion as their mission, even though the word charity, in common parlance, connotes an organization that primarily serves the poor.

For purposes of this book, the words nonprofit or nonprofit organization refer to organizations that are recognized by their states' laws as nonprofits, that are publicly supported, and that have obtained recognition of tax exempt status by the federal government under Section 501(c)(3) of the Internal Revenue Code.

The public charities that are the subjects of this book fall into eight major areas of focus:

1. *Arts, culture, and humanities*—such as museums, symphonies and orchestras, and community theatres. These may include everything from the renowned Metropolitan Museum of Art

- in New York to the tiny Tidewater Classic Guitar Society in Norfolk, VA.
2. *Education and research*—such as private colleges and universities, independent elementary and secondary schools, and noncommercial research institutions. This category includes multi-billion dollar Ivy League universities as well as small local or regional high school dropout prevention programs such as Seven Lakes High School's Project Graduation in Cut Off, Louisiana.
 3. *Environmental and animals*—such as zoos, bird sanctuaries, wildlife organizations, and land protection groups. The National Geographic Society in Washington, DC falls into this category, as do local organizations such as Friends of the Verona Street Animal Shelter Inc. in Pittsford, NY.
 4. *Health services*—such as hospitals, public clinics, and nursing facilities, mental health and crisis intervention clinics. Examples abound, large and small, from the enormous Kaiser Foundation in Portland, OR to the Trinity Group Homes for addiction treatment in Coeur d'Alene, ID.
 5. *Human services*—such as housing and shelter, organizers of sport and recreation programs, and youth programs. Nonprofits in this category include the mighty Legal Services Corporation of Washington, DC, which takes in and expends some \$350 million a year providing legal services to indigent people, and the local food pantries that feed the hungry throughout our nation.
 6. *International and foreign affairs*—such as overseas relief and development assistance, including Feed the Children (Oklahoma City, OK) and the Hands Across the Border Foundation, a small nonprofit in Boulder, CO dedicated to improving cultural understanding among citizens of the border states of Mexico, Canada, and the United States.
 7. *Public and societal benefit* organizations—such as private and community foundations, and civil rights organizations. The ACLU, is one example; the Special Equestrians of Vero Beach, FL, which provides educational and therapeutic horseback riding for the physically and mentally challenged is another.
 8. *Religion-related charities*—this includes faith-based programs and congregations large and small.²

Clearly these organizations are serving a tremendous range of interests. What do they have in common by way of legal needs? The common threads are their *missions*, their *fiduciary duties*, and their *tax-exempt status*. Let's examine each of these common elements in turn.

Laws About Mission

A nonprofit's mission is its reason for being. Charitable nonprofit organizations are intended to serve a public purpose rather than provide a private benefit to individuals, corporations, industries and others. It follows that the organization's assets and activities must be devoted to the public purpose for which it was incorporated. Everyone in a leadership role must deeply understand that the purpose of the organization is charitable, and that it must engage primarily in activities that accomplish one or more of its public purposes. Deviating from its mission can expose the organization and the people within it to serious consequences: possible personal liability for directors and officers for breach of fiduciary duty; possible removal of board members from service; state Attorney General's action to restrain the organization from carrying on unauthorized activities; reputational and monetary costs to the organization; and, in extreme cases, revocation of tax exempt status or even revocation of charter.

Many organizations, their boards, and their staff are confused about what the mission is and how to identify it. Technically the mission is what the organization has told the IRS its mission is in its application for tax-exempt status, as well as what is reflected in the organization's governing documents (its articles of incorporation and bylaws). The organization may well have updated or amplified its mission statement at board meetings or in publications, but if these updates are inconsistent with the original statement of mission, the changes do not officially change the federal tax-exempt purposes unless the IRS is formally notified. Some organizations have evolved to the point where their stated mission may be unrecognizable; such organizations would do well to consult with qualified counsel to help them update IRS filings to redefine the mission. They may also need to amend their certificate of incorporation, or bylaws, if the purpose clause included there is not written broadly enough to encompass the current activities of the organization.

In all cases, a critical job of an organization's general counsel is to continuously remind trustees and management of the centrality of the organization's mission in all decisions affecting the expenditure of organizational resources.

Laws About Fiduciary Duties

Leaders of the organization—whether they are trustees, officers, or other key players—must know and observe their fiduciary duties under state law, including:

1. The *duty of care*, which requires familiarity with the organization's finances and activities and regular participation in its governance.
2. The *duty of loyalty*, which requires directors and officers to act in the interest of the corporation and to avoid or disclose conflicts of interest or transactions that might appear to create conflicts of interest.
3. The *duty of obedience*, which requires directors and officers to be faithful to the organization's purpose and to the law.³

These duties may be expressed somewhat differently in different states, and may be supplemented by other fiduciary duties in various jurisdictions. But at their heart they express the oldest and most fundamental obligations of directors—and also of officers—to the organizations they run.

To translate the somewhat theoretical fiduciary duty of care into more practical terms: Does the board actively and knowledgeably participate in the oversight of the organization, through board meetings and activities between meetings? Or, on the other hand, are board meetings occasional and desultory affairs, with management making most or all of the presentations (or providing scripts for the board members to read), and the board acting largely as a rubber stamp?⁴

The fiduciary duty of loyalty underlies much of the discussion that follows regarding conflicts of interest. Officers' and directors' primary loyalties should lie with the organization, and not with their own personal or business interests, when they are enmeshed with the activities of governing the organization. The duty of loyalty

requires the leadership to act in good faith and in, or not opposed to, the best interests of the organization.

The fiduciary duty of obedience is also straightforward: Officers and directors should act in a way that is consistent with the central goals of the organization and with the law.

Here are some ways to tell whether the organization's board members are discharging their duties:

Fiduciary Duty Checklist

- Do board members regularly attend meetings?
- Do those in attendance carefully review the minutes and correct any errors?
- Does the board keep track of what duties are delegated to which committees, and receive follow-up reports?
- Do board members periodically meet with senior management to ascertain that organizational policies are followed and the board's vision is being carried out?
- Do they have access to, and ask questions of, outside experts such as lawyers, accountants, and investment advisors?
- Does the board genuinely debate and deliberate proposals and make informed decisions?
- Does the meeting schedule allow time for information gathering and consideration about how comparable institutions deal with similar problems?
- Does the board annually evaluate the chief executive officer and set compensation in light of comparable institutions and the work of this particular CEO?
- Does the organization have—and follow—policies and procedures for considering the fairness to the organization of proposed business transactions with insiders, such as directors or officers?
- Does the leadership know the organization's mission and keep it front and center in its decision-making?
- Does the leadership know and understand how to follow applicable laws?

Using this checklist, counsel can help leadership apply the somewhat theoretical principles of fiduciary duties to the real business of governing and running their organization.

Laws About the Tax Exemption

Notwithstanding the breadth of missions and range of sizes, nonprofit organizations face common issues relating to the tax exemption.

Tax-exempt status is a privileged status; the organization performs good works that have been deemed valuable by society, and in exchange they are free from paying most kinds of taxes. In practice, the exemption provides welcome relief from what could be significant additional lines of expense in the organization's operating statement.

Organizations can save on many kinds of taxes:

- Federal and state income taxes
- State/municipal real estate/property taxes
- State sales tax for goods sold
- Taxes on goods purchased from vendors
- Federal and some state unemployment taxes

Section 501(c)(3) organizations benefit also from the deductibility allowed to individuals, corporations, and others, of gifts to the organization. That is, gifts to charities are deductible from both income taxes and inheritance/estate taxes. Exempt organizations may also enjoy nonprofit postage rates, the ability to issue tax-exempt bonds to pay for capital construction or improvements, and other benefits large and small. Other indirect benefits may arise from undertaking activities encouraged by other incentives in the tax code.⁵ All told, the value to the sector of the tax exemption plus the tax-deductibility to donors of contributions probably tops \$125 billion a year.⁶

Make no mistake: Relieving these organizations from the burden of paying most taxes and providing a tax write-off to donors results in a higher tax burden on everyone else—taxable business entities as well as individuals. The cost borne by the taxpaying community reflects a longstanding and deeply held belief that nonprofits are of critical importance, providing nothing less than the foundation and fabric of a good, decent, and evolved society.

The tax advantages are premised on the notion that these organizations provide important benefits for society; society in turn

imposes responsibilities and constraints to hold the sector accountable. Nonprofit organizations face special legal requirements not imposed on taxable, for-profit entities or individuals: restrictions on how they may accumulate, spend, and invest funds; rules about how they may use volunteers; scrutiny of those with whom they may do business and on what terms; and exacting public reporting and disclosure requirements. These matters and others are covered in subsequent chapters.

Beyond Laws about Nonprofits: Complying with Business Laws, Too

Law is not one substantive subject; it is many. Besides complying with laws relating both to their nonprofit and exempt status (such as nonprofit corporations law, nonprofit tax law, and fundraising laws), nonprofits must also comply with laws generally applicable to other kinds of businesses, such as contract law, copyright and trademark, labor and employment, consumer protection, premises liability and more.

And the general counsel of a nonprofit organization is not just practicing law; he or she is also managing the organization's legal function by:

- Ensuring the corporation's compliance with all laws and regulations, including bylaws and organizational policies.
- Monitoring the changing legislative and regulatory environment.
- Overseeing and approving contracts, creating and updating form agreements/purchase orders; establishing and enforcing approved contracting procedures.
- Handling and coordinating any litigation and regulatory scrutiny (inquiries, investigations).
- Selecting, supervising and coordinating outside counsel where necessary.
- Advising on legal aspects of all other operational, policy, and governance matters.

The array of legal responsibilities is breathtaking. The need for competent legal advice is great. The risks of being wrong are significant. And yet most nonprofits, particularly the smaller ones with limited resources, lack regular access to legal advice.⁷ Who should

carry out these duties? A board member who happens to be a lawyer, although perhaps not trained in the legal needs of nonprofits? The CEO's best friend who is a lawyer? Other professionals on the staff who may be generally conversant with legal matters affecting their functional area?

None of these is a good solution. Clearly the nation's lawyers need to gear up to meet the vast and burgeoning legal needs of nonprofits. Just as clearly, the nation's nonprofits need to become more sophisticated in seeking out competent legal advice and taking responsibility for addressing their legal needs.

First Stop for Legal Advice: CYA (Consult Your Attorney)

Beyond doing what they do best—carrying out their missions with excellence—nonprofit organizations have a wide range of legal responsibilities, from protecting and preserving the nonprofit corporate status, mission, and tax exemption, to attending to a vast array of business law and other matters. The role of qualified counsel is to help the organization successfully navigate these challenges so that it may most effectively pursue and achieve its mission.

Organizations, their trustees, and managers should beware of seeking legal advice on behalf of the organization from nearby people who happen to be lawyers such as board members, friends, acquaintances, and others, if such persons are not equipped and empowered to act as counsel to the organization. Board members who are lawyers may experience some role strain—or worse—when asked to provide legal advice to the organization.



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An attorney who advises the board on a legal issue upon which he or she may then have to vote as a trustee creates an ethical problem for the lawyer, and may even pose a professional conflict of interest.

Asking a trustee who happens to have a law degree for legal advice makes the boardroom an awkward place when the lawyer gives counsel that the board chooses not to follow. Aside from

the ethical quandary, it is rare that a board member who is also a lawyer has formally taken on the organization as a client and properly assumed full ownership and responsibility for a nonprofit legal matter in a way necessary for proper client representation, characterized by focused and zealous representation of the nonprofit's legal needs. Indeed, some law firms or their malpractice insurance carriers will not even allow one of their lawyers to serve simultaneously as a board member and as counsel to an organization.

That is not to say that organizations should not bring on lawyers as board members, or that they should not use those lawyers as a sounding board on legal matters for which they are receiving qualified advice from an independent, expert counsel. They just should avoid relying on the trustee-lawyer alone to make legal decisions or render legal advice to the organization.

Another common pitfall is the passing along of received legal wisdom by various non-attorneys within the organization. Fundraisers, finance, human resources, or marketing managers may have just enough legal knowledge based on their experience in the field or in business to be dangerous, but they should not try to perform legal duties. Regardless of how savvy they may feel, those lacking legal training and a license to practice law in their state are not an adequate substitute for retaining independent and knowledgeable counsel.

On the other hand, seasoned nonprofit managers who are attuned to legal issues can be great allies to the lawyer who is officially charged with providing legal advice to the organization.

Nonprofit trustees and managers can be excellent issue-spotter, reliably identifying legal issues at an early stage and bringing in counsel to advise them through the situation.

Legal Education for Non-Lawyers

Counsel's job is to make sure that the organization's trustees and managers are familiar with the kinds of legal issues that may affect each function or department. The lawyer should work closely and regularly with those charged with each function of the organization to sensitize them to the legal issues likely to arise. Once sensitized, these individuals should promptly bring such matters to the

attention of counsel—earlier is better so that minor or latent issues do not turn into big problems. Non-legal colleagues should also be educated about how to take and implement legal advice, and how to preserve its privileged character.

Even if the organization is fortunate to have in-house counsel or regular access to outside counsel, a generalist counsel may not be enough. If the matter is specialized, counsel should seek expert legal advice. In the same way a family doctor refers a patient with heart problems to a cardiologist, the general counsel refers specialized matters to legal experts.



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The close working relationship between counsel and trustees or managers of an organization should not be misconstrued as an attorney/client relationship between the lawyer and any one individual. The client is the organization; the attorney/client relationship pertains to the counsel's advice to the trustees and managers in their roles on behalf of the organization, and not as individuals.

In Sum/Coming Up Next

Nonprofits bear some similarities and some striking differences to their for-profit counterparts. In both contexts, legal issues are myriad. An organization's counsel, whether paid or pro bono (volunteer), must maintain a high profile within the organization, reaching out to members of the board, especially on governance issues, and to staff in every functional area, so that they are fully conversant with the range of legal matters likely to arise. An attorney who is attuned to good governance and focused on legal compliance is a firm pillar of the organization's fulfillment of its mission.

How counsel can best achieve these ends is the subject of the next and later chapters. In the meantime, the following series of Focus Questions helps to underscore the points raised in this chapter.

The Chapter 1 Work Plan helps users understand the organization's overall legal context and begin to formulate plans to meet the organization's legal needs.

Focus Questions for Chapter 1: The Legal Context of Nonprofits in the United States

1. What distinguishes a nonprofit organization from a for-profit organization?
2. What happens if a nonprofit organization deviates from its mission? If it is used primarily for the benefit of select private individuals?
3. List and describe the three basic fiduciary duties of directors and officers under most states' laws. What consequences result from breach of these duties?
4. List several kinds of taxes that tax-exempt organizations save on, and other kinds of benefits from being tax-exempt. From what kinds of taxes are tax-exempt organizations *not* exempt?
5. What is a tax-exempt organization? Are contributions to all tax-exempt organizations tax deductible to the donor?
6. What are some key areas of nonprofit organizations' legal needs?
7. Besides providing substantive advice, what are some of the other law practice management duties a nonprofit's lawyer may be called upon to perform?
8. What are some common forms of lawyering outside an established client relationship in the nonprofit organization context? Why should it be avoided?
9. What are some risks and opportunities when a lawyer serves on a nonprofit board?

Chapter 1 Work Plan

Understanding an Organization's Basic Legal Context and Setting Goals

This work plan assists users in understanding the organization's overall legal context and begins to formulate plans to meet the organization's legal needs.

- ❑ Become familiar with the organization's mission, its programmatic functions, and activities.
- ❑ Understand who are the organization's key stakeholders: What are their interests in the organization, and how are those interests being served?
- ❑ Obtain and review the following key documents (guidance about what to look for in each of these documents appears in subsequent chapters' work plans):
 - Certificate of incorporation, and any amendments filed.
 - Current bylaws.
 - IRS tax exemption letter.

(continued)

- List of members of the board or governing body, including length of service, committee assignments, and any other board or corporate affiliations of each member.
 - List of senior managers (direct reports to the CEO/Executive Director), their experience in their functional area, length of service, and current job descriptions; ascertain who is responsible for core managerial functions.
 - Current operating budget.
 - Financial statement.
 - Business or strategic plan (if applicable).
 - Most recent IRS Informational Returns (Form 990) and state charities office annual filings.
- ❑ Take a legal history of the organization:
- Who incorporated the organization, and when? Obtain copies of the founding documents.
 - Does the organization currently have legal counsel?
 - What was the nature of any legal services rendered over the past several years, and by whom were they rendered?
 - Is the organization aware of local legal services groups that provide free or low-cost legal advice to qualifying nonprofits?
 - Who interacts with outside legal counsel on behalf of the organization?
- ❑ Does the board conduct orientation and training of members? What materials does it use?
- ❑ Is the organization considering a major structural change, such as a merger, joint venture, strategic alliance, partnership, dissolution, bankruptcy filing/restructuring of debts, or a change of mission, name, location, or service area?
- Similarly, determine whether the organization wishes to terminate, modify, or renegotiate the terms of such a joint arrangement.
- ❑ Ascertain whether there are any current or recent interactions with government regulators.
- Pending, threatened or imminent litigations, investigations, or governmental audits?
- ❑ Find out whether the organization is undergoing or anticipating a major change in leadership or governance.
- ❑ Are there any other overarching, pressing legal needs or concerns? Who has primary responsibility for identifying and addressing current and imminent legal needs or concerns?

- ❑ What are the organization's expectations coming out of this legal review, and what time and resources are available?
 - Short term (over the course of a calendar quarter or school semester): Conduct a function-by-function review of the organization's legal needs; locate resources to help address the most pressing questions.
 - Medium term (over the next one to three years): Prioritize and address non-urgent items that surfaced in the initial review; implement measures for ongoing assessment and education; formalize legal relationships and improvements.
 - Longer term (over the next three to five years): Review impact of legal and governance improvements on achievement of mission; flow positive results through to new initiatives, new grant applications, and new sources of funding; continually improve systems for detecting and addressing legal matters; develop and strengthen ongoing ties to knowledgeable members of legal community.
- ❑ What would the organization consider to be a good outcome of this legal overview? Are board, senior management and other important stakeholders aligned?

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