

# Representing Nonprofits (i.e., the Good Guys)

By Lisa A. Runquist



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**W**hen people ask me what I do, I tell them that I represent people who wear the white hats—the good guys. I can say this because I have found that most people who work with nonprofits do so with the best of intentions. Unfortunately, there is sometimes a large gap between these intentions and the end result. Often this is because of a lack of knowledge or a lack of understanding of what is actually required to comply with the law in organizing and operating a nonprofit organization. You may well already be involved with such an organization—for example, you might be involved with your church or synagogue, the school your children attend, your local sports league, museum, local soup kitchen, or scouting organization. In fact, you might already be a volunteer for the organization or serving on the board. Or you may have wanted to give the organization some legal advice but realized that you really know nothing about nonprofits. Hopefully, this article will give you an impetus to get going!

### FORMATION, ORGANIZATION, FILINGS

Most nonprofits that are formed by attorneys are corporations, formed pursuant to state law. It is generally best to form the corporation in the state in which it is operating, unless you have concerns about that particular law (many New York nonprofits are formed as Delaware corporations). If the corporation operates in a number of states, compare the laws of these states to see if one is better than another. The principal areas that will differ between state laws involve indemnification and limitation of liability of volunteers (including directors and officers).

A corporation is formed by filing articles of incorporation with the secretary of state or similar officer. It also adopts bylaws, which set forth the internal workings of the organization (whether it has members, how directors are elected, requirements for holding meetings, provisions concerning committees, officers, etc.). The articles are the birth certificate for the organization and include the name, the nonprofit purpose, the agent for service of process, and, for

tax-exempt charitable organizations, provisions required by the Internal Revenue Service (IRS) mandating that all assets be used for these charitable purposes and providing that upon dissolution the assets will go to another similar organization.

Sometimes articles have other provisions (such as whether the organization will have members). Sometimes these provisions are required by state law, but often they are not. If these provisions conflict with the actual operation of the organization, or with provisions of the bylaws, the articles will control. Once the articles are filed with the secretary of state, the organization will often store them and forget about them, as they do not need to be referred to regularly. The organization will then make whatever modifications are necessary to the operations by amending the bylaws—without making sure there is not a conflicting provision in the articles. For example, I have seen many situations where the articles specify the number of directors, but the bylaws and actual practice conflict. If the matter is litigated, the court may find that the organization is operating improperly. To make sure that this does not happen, you should review the articles on a regular basis. Periodically, you may need to amend the articles to ensure that the organizational structure conforms to the actual operations.

If you cannot find the articles of incorporation for the nonprofit, and the secretary of state has no record of the organization, it is possible that the organization was never incorporated. Many nonprofits simply begin to operate without having put together the standard paperwork needed. All is not lost. A nonprofit may operate as an unincorporated association and still be exempt from taxation. Or you may decide to incorporate the nonprofit to obtain the extra protection usually given to corporations. If the association wants to establish its exempt status, it will need to have some organizational documents (articles of organization/bylaws).

This brings up another important point: Just because an organization has been formed as a nonprofit does *not* make it tax exempt. To be exempt from taxation

as a 501(c)(3) charity, the organization, with limited exceptions (e.g., churches), must file a Form 1023, Application for Recognition of Exemption, with the IRS. If the organization qualifies, it can file a Form 1023-EZ instead, which is much easier and faster. In either event, the organization must be both *organized* (e.g., articles, bylaws) and *operated* for charitable purposes. Some states require that you also file with them to establish the exempt status of the organization. To make sure that your organization qualifies, you should ask to see the exempt determination letter from the IRS (and perhaps from your state), as well as the original filing of the Form 1023 or Form 1023-EZ. If the organization cannot find it, you can check the IRS website to see if it is listed as being exempt. You might also check on [guidestar.org](http://guidestar.org).

In addition to having filed to establish the exempt status of the organization, nonprofits are required to make an annual filing with the IRS. Depending on the size and complexity of the organization, this might be Form 990, Form

statement of information be filed every other year with the secretary of state, that an original filing (CT-1) be made with the attorney general when the organization begins to receive money, and that a Form RRF-1 be filed annually with the attorney general thereafter, that a Form 3500 or a Form 3500A (if the organization has its exempt determination letter from the IRS) be filed initially with the Franchise Tax Board (FTB), and that a Form 199 or equivalent form be filed annually with the FTB thereafter. Other filings are required if the organization is going to engage in public solicitation of funds and to establish a property tax exemption on any property owned by the organization.

### OPERATION OF THE NONPROFIT

There are numerous significant issues that you are likely to run into if you are representing a nonprofit. Here are a few that I regularly see:

**Reasonable salaries.** The nonprofit must use all its assets to benefit the exempt purpose(s) for which it was formed.

objective facts, such as a salary survey. In addition, the compensation should be determined by disinterested directors (the person receiving the salary or his or her relatives cannot be involved), and there needs to be a record made and approved of the decision (e.g., minutes of the meeting).

**Personnel matters.** The vast majority of lawsuits involving directors and officers insurance have to do with personnel matters, such as discrimination, harassment, and wrongful termination. The basic approach is that the law is essentially the same for nonprofits as it is for businesses. There are differences, especially for churches, but you will not go wrong if you adhere to the standard employment practices recommended for businesses. But see “reasonable salaries” above.

**Fiduciary responsibilities.** Directors of a nonprofit are often unaware of their responsibilities and duties. Some think that it is more of an honorary title, or believe that, because they provided funding to the organization, they have no further responsibilities. Nothing could be further from the truth. As with a business corporation, there is a duty of care and a duty of loyalty. Each director must attend meetings and must review materials provided, preferably before the meeting. If the director has serious questions about a matter, he or she should insist on being provided with the answers before a vote is taken. The director must look out for the best interests of the organization, rather than the director’s best interests. Even if a director is elected by a particular group, the director should not vote for what is best for that group but what is best for the organization. If there is a conflict of interest, the director should not vote on the matter. Directors should never simply approve what the president has proposed—they cannot act as “rubber stamps.”

**Financial oversight.** In addition to setting policy and providing direction concerning the activities of the organization, directors must also review the results. This includes not only overseeing the president but also making sure that the nonprofit is raising sufficient funds for the operations and is using these funds in a manner that advances

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990-EZ, or, for most small organizations, Form 990-N, more commonly known as an e-filing, which is a simple form that can be filed only online. If the organization fails to file the appropriate annual informational return for three years, then its exempt status will be automatically revoked; therefore, one of the most important things you can do is to make sure that these filings have been made and establish a process to keep them up-to-date.

You also should check to see that all filings required by the state are current. For example, California requires that a

Assets cannot be used to benefit a private person. Of course, it can pay its employees, but these employees must have jobs that are necessary to carry out the purposes of the organization. In addition, the salaries and any other benefits paid must be reasonable. When determining what is reasonable compensation, especially regarding the CEO, the CFO, a director, or any other individual who is (or has been within the past five years) in a position to exercise significant influence over the organization, the board should set the compensation based on outside

the purposes of the organization. Some states require organizations of a certain size to have a certified audit. Even when there is an audit, the directors have the ultimate responsibility to make sure that the funds are correctly used and should meet with the auditor to discuss any concerns or problems that the auditor may have discovered.

**Commercial operations/joint ventures.** Sometimes nonprofits become involved with business types of activities. If these activities are unrelated to the nonprofit operations, the nonprofit might have to file Form 990-T and pay unrelated business income tax on the profits. If the commercial activities are a significant part of the nonprofit's operations, the tax-exempt status of the organization may be endangered. If the nonprofit undertakes an activity in conjunction with a business entity, there must be enough control over the operations by the nonprofit to ensure that the activity is being operated to advance the nonprofit purposes of the organization. Otherwise, this will also be considered a commercial activity that may result in taxes or may endanger the exempt status of the organization.

### I SERVE ON THE BOARD—CAN I ALSO BE THEIR LAWYER?

Attorneys are often asked to serve on the board of their local nonprofit(s). What is commonly assumed, but is generally not expressly stated, is that the attorney will also be able to offer free legal advice to the organization. This brings up a number of issues. The following discussion is not a definitive list of these issues but presents some of the initial concerns you should consider.

The first and foremost is: Do you know the law in this area? If not, are you prepared to get up to speed? Whether or not you are paid to perform legal services, you can be sued if the advice you give is incorrect. Therefore, if you want to provide legal advice to your nonprofit, you must make sure you are knowledgeable.

Then there are the times that you might simply be expressing your opinion on what might be best for the organization in a given situation. Do your fellow

board members know that you are *not* providing legal advice? Sometimes opinions of an attorney are given more weight than they merit because the listener thinks that the attorney knows and is giving a legal opinion. It is important to make sure that you distinguish between statements you make that *are* legal advice and your input on business decisions.

**Do you want to be both an attorney for the organization and a director? Is it worth the risk?**

This issue should be addressed as soon as you are first asked to serve on the board. Right from the outset you should make it clear that, as a board member, you will *not* be serving as the attorney for the corporation, unless you specifically agree to particular representation. Indeed, going back to the first point, you may tell the organization that you do not know nonprofit law (or employment law, etc.) and are not qualified to provide legal advice except in the areas of your expertise.

Legal advice is subject to the attorney-client privilege. In order not to waive the privilege, you must take the same steps you would otherwise to protect the privilege, such as making sure that there are no individuals in the meeting who do not need to be there and that the board is notified that your work product is subject to the attorney-client privilege



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and should not be disseminated.

If the organization is being sued and you are on the board, it is possible that the other side will want to take your deposition. In such a situation you may not be able to serve as legal counsel for the organization.

Of course, many attorneys decide they want to represent the organization despite these issues. If this is you, one very important matter to consider is whether, in the event of a lawsuit, you will be covered by the directors and officers insurance, or whether you will be covered by your malpractice insurance, or whether both insurance policies will want to deny coverage. If you make it clear when you are giving legal advice and when you are not, your malpractice insurance may be on the hook for the former, while the directors and officers insurance may be on the hook for the latter.

And even if you have informed the organization that you are not its attorney, that you are not providing legal advice, and that you are only serving as a director, you may still not be in the clear. To comply with the duty of care, a director must make his or her decisions in the way a reasonably prudent person in a like position would decide. This means that each director cannot leave his or her experience at the door but must make these decisions based on what he or she knows to be the case. If you do know the law in a particular area, you cannot simply ignore what you know (although, instead of providing a legal opinion, you can simply point out your concern and suggest that an attorney be consulted).

So, do you want to be both an attorney for the organization and a director? There may be specific situations where you decide it is worth the risk. But otherwise, I would recommend that you decide which hat you want to wear. Just make sure it is white. ■