GUIDEBOOK FOR BOARDS OF DIRECTORS OF NORTH CAROLINA NONPROFIT CORPORATIONS

(2nd edition)

A cooperative project of:

Business Law Section
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and

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This Guidebook is not intended to give legal advice.

Please contact an attorney licensed
in your jurisdiction for legal advice.

INTRODUCTION

Welcome to the board of directors! As a nonprofit board member, your talents and wisdom will be appreciated – and tested. You will face challenges, and there will be successes and disappointments. Your reward will come from working with fellow board members and the nonprofit's staff to create value for the people whom the nonprofit serves.

This guidebook provides an overview of your role and responsibilities as a board member of a North Carolina nonprofit corporation. It has four parts:

- The Nonprofit Corporation – A Primer
- The Nonprofit Board – Some Essentials
- The Duties and Liabilities of Nonprofit Board Members – Take Note
- Tax Exemptions for Nonprofits – "Need-to-Know" Basics

Purpose of guidebook. The guidebook is meant as a checklist of matters for you to consider and questions for you to ask as a nonprofit board member. Sprinkled throughout the book are pointers describing "good practices" for nonprofit boards, along with examples drawn from the experiences of other nonprofits. Often this guidebook will urge you to adopt formalities that you might find excessive. These formalities are not mere ceremony – they are meant to assure that you and your fellow board members stay focused on your mission. Observing formalities will also help to protect you and the organization from potential liabilities.

What This Guidebook Is *Not*

This guidebook is intended as a resource for individuals who serve as board members of nonprofit corporations in North Carolina. It is not meant to be a comprehensive manual on structuring, forming, or financing a nonprofit organization.

Nor is this book meant to give legal, accounting, or tax advice, though it identifies when obtaining professional services will be worthwhile. Whenever in doubt, you should seek professional advice – including through the N.C. Center *for* Nonprofits' "One-Hour Pro Bono Program," described at www.ncnonprofits.org.

Nonprofits in context. Nonprofit organizations are a vital part of the fabric of communities across this country. According to recent estimates, nonprofits account for 12% of our national economy. The IRS has tracked the growth of nonprofits over the last half century, which have multiplied twenty-fold – from 50,000 in 1950, to 250,0000 in the mid-1960s, to more than one million by the mid-1980s, and to 1.4 million in 2006 (National Center for Charitable Statistics).

Nonprofits, small and large, play a growing and critical role in American life. Unlike some other countries that leave to government the delivery of health care, arts programs, indigent services, crisis

counseling, youth programs and higher education, we have turned to private self-help – in the form of nonprofits. And over the last decade, as government services have contracted, the importance of our nonprofits has expanded.

Nonprofits count on volunteer leaders -- people like yourself -- to help solve the many problems we as a society entrust to them. By joining the board, you have become part of the solution!

Part 1
The Nonprofit Corporation - A Primer

This part describes –
- the nature of a nonprofit corporation
- the reasons for incorporating a nonprofit organization
- the basic nonprofit documents - articles of incorporation and bylaws
- the ways a nonprofit can restructure itself

As a board member, you should become familiar with the organizational structure of your nonprofit. What does it mean that the nonprofit is a corporation? How are powers distributed in the corporation? What documents lay out corporate powers, duties, and rights?

There are many kinds of nonprofit organizations – including art museums, private schools, health care providers, social clubs, foundations, business leagues, and homeowner associations. Despite wide differences in their functions and operations, most nonprofit organizations choose the same legal structure. Generally, nonprofits are organized as corporations, with a single board of directors composed of unpaid volunteers who oversee the nonprofit's work.

"Good Practices" Pointer

If you are considering forming a nonprofit, the following are excellent resources for forming a nonprofit corporation:

- The N.C. Center for Nonprofits describes the initial steps in creating a 501(c)(3) nonprofit organization – www.ncnonprofits.org/faq/HowToStartA501(c)(3)Nonprofit.pdf.
- The N.C. Secretary of State's office has a set of instructions and forms on its website – www.secretary.state.nc.us/corporations.
- *How to Form a Nonprofit Corporation* by Anthony Mancuso (8th edition, Nolo Press 2007).

1.1 What is a nonprofit corporation?

Some "corporation" basics. A corporation is an entity recognized by law as separate from the individuals who form it and who participate in its activities. A nonprofit corporation, like a business corporation, requires government recognition. To obtain that recognition, the entity must go through a process called *incorporation.* It is not enough that people with a common purpose simply agree to act as a corporation.

A nonprofit corporation can be formed in North Carolina by filing a document, called *articles of incorporation*, to the Secretary of State's office in Raleigh. The articles of incorporation (sometimes called

a *charter*) list certain fundamental terms of the corporation. After incorporation, nonprofits must adopt detailed rules on how the nonprofit will be run. These rules are called *bylaws*. In the event of a conflict between the articles of incorporation and the bylaws, the articles prevail.

North Carolina's nonprofit corporations statute provides for a *board of directors*. (In this Guidebook, we refer to "board members" rather than "directors" to avoid confusion with the nonprofit's chief executive, who is often referred to as the nonprofit's "executive director" or "ED.") The board is presided over by an officer of the corporation who sometimes is called the *board president* or the board chair.

The board exercises corporate powers, including appointing the chief executive officer (CEO) or executive director (ED) and other officers. The board delegates powers to *officers*, *administrators, executives,* and *staff* who act for the corporation in its day-to-day operations. By contrast, individual *board members* generally have no power to act for the corporation, except by participating and acting as a member of the board.

Some nonprofits, particularly those that rely on membership fees, have *members* with voting rights that are specified in the articles of incorporation or bylaws. One of the most common voting rights given to members is the right to elect board members. Many nonprofits do not have members. In such cases, the board often elects the board members and is said to be "self-perpetuating."

"Good Practices" Pointer

As a board member, you should have a folder or binder that contains your nonprofit's important documents (which you should keep in an accessible location so you can refer to them easily):

- a calendar of nonprofit meetings and events
- the articles of incorporation and bylaws
- the nonprofit's mission statement
- a list of board members (including board committees and chairs) and staff liaisons – with addresses, phone numbers, and e-mails
- the nonprofit's most recent financial statements.

Before your term of office begins, you should read the mission statement and the articles and bylaws. You should know the corporation's purposes, the mechanics of board meetings and voting, and the various functions of the officers. You should also determine whether the nonprofit has members and, if the members have voting rights, what matters they can vote on.

North Carolina's Nonprofit Corporation Act. The structure of nonprofits incorporated in North Carolina is described in the state's statute for nonprofit corporations. (The North Carolina Nonprofit Corporation Act, Chapter 55A of the General Statutes, is available on the website of the N.C. General Assembly - www.ncleg.net/gascripts/statutes/Statutes.asp).

The statute specifies that a nonprofit corporation can be formed for any legal purpose. This allows

North Carolina nonprofits to engage in business activities, so long as they ultimately serve nonprofit purposes. There is a significant limitation for *charitable and religious* nonprofit corporations. Charitable and religious corporations cannot distribute their income to members, directors or officers – except to pay reasonable salaries, and, in most but not all circumstances, as fees for services or for other value received. Other nonprofit corporations, if creditors are not impaired, can distribute their income to purchase membership interests from their members.

"Good Practices" Pointer

If a question arises whether the statute permits particular activities of the nonprofit, you may be in a "gray" area where you should consider seeking legal advice. Be aware also that some activities, even though permitted by state statute, may affect the nonprofit's tax-exempt status or subject a nonprofit and its board members to penalties (discussed in Part 4).

Other organizational forms. Corporations are not the only game in town. A nonprofit can also choose to be organized as a limited liability company (LLC), an unincorporated association, or a trust. An LLC, like a corporation, is a separate legal entity that must file organizational documents with the North Carolina Secretary of State. Under recently enacted legislation, an unincorporated association offers its members and its governing body protection against individual liability similar to that offered by a corporation or an LLC.

This guidebook focuses on nonprofit corporations, which are the most common organizational form for North Carolina nonprofits exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code – so-called 501(c)(3) nonprofit organizations.

A taste of history. The first nonprofit corporation in the United States was Harvard College, which in 1636 the Massachusetts legislature placed under the authority of a board of 12 overseers (6 ministers and 6 magistrates) and later chartered in 1650 as a corporation with an administrative body consisting of a president and fellows. This division of function, between an oversight board and accountable executives, continues to this day in most nonprofits.

From the beginning, U.S. nonprofits have felt the tension between their private and public natures. Is a nonprofit an extension of government or is it autonomous? In 1816 the New Hampshire legislature attempted to take over Dartmouth College by passing a bill that removed the College's self-perpetuating board of trustees and replaced them with new trustees appointed by the governor. The deposed trustees brought a lawsuit in state court, and the legislature responded by asserting that the College was a public institution over which the legislature had complete authority. The state court dutifully agreed. The case then went to the U.S. Supreme Court, where Daniel Webster argued that the state law was an unconstitutional interference with contract – namely, the College's original charter. In a landmark decision by Chief Justice John Marshall, the U.S. Supreme Court held that the charter, which had been the basis for persons making charitable donations to the College, was binding and the legislature could not interfere with it. In short, the public will could be expressed not only through government institutions, but also through private associations.

Although the Jeffersonian view – that private charitable and educational institutions are accountable to

government – lost in the *Dartmouth College* case, this view has flourished in the last several decades. Courts have imposed greater duties on nonprofit board members; the Internal Revenue Code has imposed conditions (such as nondiscriminatory policies) on nonprofits seeking tax-exempt status; and some state statutes even authorize state attorneys general to gauge the "charitableness" of exempt organizations.

1.2 Why are nonprofits formed as corporations?

Forming a nonprofit as a corporation – rather than as a limited liability company, unincorporated association or trust – creates a number of desirable *corporate* attributes.

Separate entity. Once incorporated, the nonprofit becomes a recognized legal entity, separate from the individuals who carry out its operations. The corporation has a life of its own and continues as individual members come and go. The nonprofit corporation can enter into contracts, hold property, sue and be sued – just like any other person. A corporate employer can offer employee benefits such as health insurance, group life insurance, and retirement plans.

Limited liability. The corporation's board members, officers, staff, and members are not personally liable for the corporation's obligations. In most situations, participants in the nonprofit are insulated from liability for the corporation's contracts or the negligence of its employees or agents.

Governance structure. An incorporated nonprofit adopts the structure of a "nonprofit corporation," with all the powers and rules that nonprofit corporate law lays out for such entities. Under North Carolina law, for example, a nonprofit corporation can do most things a for-profit corporation can do, except distribute surplus funds in the form of dividends. Surplus funds must remain in the nonprofit, for use in its operations and programs.

Choosing the corporate form also simplifies a non-profit's tax-exempt status, since the IRS has clearer guidelines for recognizing tax-exempt status and determining compliance with tax-exemption rules for corporations than for the other organizational forms.

Example

The nonprofit's van runs over a neighbor's flower garden – and the employee who drove the van is found to be negligent. The corporation can be liable, and also the employee who drove the van, but normally the corporation's board members are not liable and their individual assets cannot be seized to satisfy the judgment.

Volunteer's liability. Limited liability has become important as nonprofits become more exposed to litigation risks. For example, following a trend in other states, North Carolina no longer recognizes the doctrine of "charitable immunity" which made charitable nonprofits immune from lawsuits arising from injuries caused by employees or agents (including volunteers). North Carolina law still provides immunity for nonprofits and volunteers in cases of non-vehicular civil liability when the volunteer acted

in good faith and was reasonable under the circumstances, except to the extent liability insurance covers the volunteer's negligence.

> **"Good Practices" Pointer**
>
> Legally, volunteers are agents of the nonprofit, and their negligence can bind the corporation. Just because the volunteer was uncompensated does not exonerate the nonprofit. The board should make sure that volunteers are trained and supervised. It may also be useful to check whether the corporation's insurance covers the organization for actions of volunteers.

State licensing of charitable solicitations. As a general matter, nonprofit corporations (once incorporated) may conduct their operations in the state without further state filing requirements. There is, however, one licensing requirement. North Carolina regulates the solicitation of charitable contributions. Absent an exemption, any nonprofit that plans to solicit charitable contributions or engage in charitable sales promotions must first obtain a license. (Exemptions exist for religious and educational institutions, hospitals, hospital foundations, non-commercial radio and TV stations, qualified community trusts, volunteer fire departments, rescue squads, emergency medical services, YWCAs, YMCAs, and continuing care facilities.)

Licensing is required even if the soliciting is done by non-professional fundraisers, such as the nonprofit's board members and staff. A license can be obtained from the Charitable Solicitation Licensing Section of the Office of the Secretary of State. (Nonprofits that receive less than $25,000 per year in contributions are exempt from this licensing requirement, so long as they do not compensate their board members, officers, fundraisers, or solicitors.)

1.3 What should the articles of incorporation and bylaws contain?

Here is a checklist of what you should find in the corporation's articles of incorporation and bylaws.

Articles of incorporation. North Carolina's Nonprofit Corporation Act requires that the articles of incorporation contain the following information:

- the corporation's name
- a statement whether the corporation is a "charitable or religious corporation"
- the name of the registered agent (the person who receives legal notices for the corporation)
- the address of the registered office (for official correspondence)
- the address of the principal office (the main place of operations)
- a statement whether the corporation has members
- provisions for the distribution of assets on dissolution
- the name and address of the incorporators

Purposes. The corporation's statement of purpose, though not required under North Carolina law, is important for its tax-exempt status. For 501(c)(3) organizations, the articles of

incorporation must state expressly that the corporation's purpose is one or more of the following: "charitable," "religious," "educational," "scientific," "literary," or "lessening the burdens of government," and also should articulate the particular purposes for which the nonprofit is organized and operated. If the nonprofit's mission changes significantly, it is important to amend the articles to reflect the changed purposes.

Members. If the nonprofit has members, this will be stated in the articles. Under North Carolina law, simply stating that the corporation has members does not define their rights and duties. The members' voting and informational rights (if any) must be specified in the articles of incorporation or bylaws.

Distribution of assets on dissolution. The final stage in a nonprofit's life is "dissolution" – the process by means of which the legal existence of the corporate entity ceases. A statement in the articles of incorporation describing how assets will be distributed on dissolution is important to assure recognition of tax-exempt status. Under North Carolina law and the Internal Revenue Code, a "charitable or religious corporation" may distribute its assets only to another "charitable or religious corporation," another 501(c)(3) nonprofit organization, or to federal or state government. This ensures that assets meant for charitable or religious purposes remain dedicated to the original intent of the dissolving nonprofit.

Powers. Generally, a nonprofit corporation can do anything a for-profit corporation can do, except distribute surplus funds in the form of dividends. Specific restrictions may be necessary to qualify for 501(c)(3) tax-exempt status – for example, limits on distributing net earnings, paying only reasonable compensation, not engaging in *substantial* lobbying activities (although 501(c)(3) nonprofits can lobby within limits), and not participating in political campaigns. Unless stated otherwise in the articles of incorporation, a nonprofit corporation has perpetual life.

Requirements for 501(c)(3) organizations. To qualify for 501(c)(3) tax-exempt status, nonprofits must include provisions in their articles of incorporation that provide: (a) no part of net earnings will inure to the benefits of the nonprofit's directors, officers, members, or any other private person; (b) no substantial part of its activities will be attempts to influence legislation; (c) it won't, directly or indirectly, participate in, or intervene in any political campaign on behalf of, or in opposition to, any candidate for public office; and (d) it has no authority to issue capital stock. For private foundations, the articles should acknowledge that the organization will abide by the rules for private foundations set forth in Sections 4941-4945 of the Internal Revenue Code.

Additional optional provisions. The articles can include additional provisions on such matters as indemnification of board members and officers, limitations on director liability, and any limitations on rights and powers of members. Generally, any amendments to the articles must be approved by the board and, in a membership nonprofit, also by the voting members.

Bylaws. The bylaws lay out the nonprofit's internal rules. They are not filed with the Secretary of State, and there are no requirements on what they contain, except that they must be consistent with the articles of incorporation. Typically, bylaws will contain the following provisions:

Purpose. The statement of purpose typically will be the organization's mission statement. These purposes should be consistent with those articulated in the articles and should be amended (along with the articles) if the nonprofit's mission changes significantly.

Principal offices. The bylaws should state the address of the current principal office. This should be amended if the nonprofit moves its offices.

Members. If the nonprofit has members, and if the articles of incorporation do not specify the rights of the members, the bylaws should specify their rights. Under North Carolina law, members of nonprofit corporations have no rights other than those provided in the articles and the bylaws. If the members have voting rights, there should be procedures that address how members vote, on what matters, and how much notice is required.

Board members. The bylaws should describe the number of board members (or the range for the number of board members), any qualifications required, and the procedures for board meetings, including notice requirements. Under North Carolina law, only one board member is required, but it is good practice to have at least 5-7 board members. The bylaws should also specify the names, functions, and powers of board committees. Sometimes the bylaws will contain (or repeat) the provisions on indemnification of board members and officers.

Officers. The bylaws should specify the nonprofit's officers and their functions – such as executive director, president (or chair), vice president (or vice chair), secretary, and treasurer. North Carolina law permits one person to hold multiple officer positions simultaneously, but it doesn't permit the individual to act in more than one capacity where the authority of two or more officers is required. Generally, even on a very small board, it is good practice to have a separate president or board chair and treasurer. It is important to specify their functions to make clear who has the authority to enter the nonprofit corporation into binding contracts and other transactions with third parties. Often, the executive director will have the authority to enter into small contracts, but the board must approve transactions exceeding a certain dollar amount.

Conflicts of interest. The bylaws should specify the nonprofit's rules and procedures for conflict-of-interest transactions involving board members, executives, staff, and volunteers – such as the sale of goods to the nonprofit or the use of nonprofit property. In addition, the nonprofit should have a written conflict-of-interest policy applicable to its board, executives, staff, and volunteers. Board members should understand the policy before agreeing to serve, and all affected persons should sign the policy and provide written notice of any actual or potential conflicts of interest upon beginning service and afterward on an annual basis.

General provisions. The bylaws should specify the nonprofit's fiscal year and describe how the bylaws can be amended (typically requiring board approval and member approval for at least some types of bylaws amendments in membership nonprofits). Bylaws, which in general are easier to amend than the articles of incorporation, are frequently amended. The version you read should have a date with an indication of when it was last amended.

"Good Practices" Pointer

Sample articles of incorporation and bylaws are available on the Internet. Forms related to North Carolina nonprofits can be found at:

- N.C. Secretary of State's website - www.secretary.state.nc.us/corporations/
- N.C. Center for Nonprofits' website - www.ncnonprofits.org/faq/HowToStartA501(c)(3)Nonprofit.pdf

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1.4 How can a nonprofit restructure itself?

Nonprofits, like for-profit businesses, live in a world of change. As funding shifts or needs change, nonprofit boards should periodically reassess their mission, strategy, and service niche. When this happens, it may become apparent that the nonprofit should undertake a fundamental change. But restructuring may not be easy, since it sometimes involves acknowledging that the nonprofit faces a financial or programmatic crisis. What are the restructuring options?

Fiscal sponsorship allows an established nonprofit to act as "host" for a new 501(c)(3) nonprofit project. In this way, charitable funds can be directed to nonprofit activities while the nonprofit develops an organizational structure. The established nonprofit must exercise oversight, since it becomes financially and legally liable for the project it is sponsoring. Sometimes the new project will become a separate nonprofit corporation; other times it will be absorbed into the established nonprofit or another nonprofit, or it may prove not to be viable.

"Good Practices" Pointer

If the nonprofit plans a major change in its use of assets that are subject to restrictions by donors, it may be necessary to obtain permission from the N.C. Attorney General's office and the N.C. Secretary of State's office. You might want to consult an attorney. Sometimes permission can be obtained informally, other times it may be necessary to bring a so-called *cy pres* (equitable interpretation) proceeding in court so any original limitations can be re-interpreted according to their general intent.

Collaboration through consolidating functions has become more common. For example, a group of community health-care clinics might decide to lower costs by sharing back-room functions (management information, billing, human resources, contracting) while continuing to serve their own geographic constituents. Collaboration is often challenging because of differences in organizational cultures and the fear of losing control. Building trust and understanding between nonprofits takes time, but collaboration can, in some cases, be the key to accomplishing a joint mission.

Joint ventures are a formal collaboration in which nonprofits enter into defined-purpose undertakings

with other organizations. For example, three nonprofits that provide foster care for troubled children may form a new nonprofit corporation or limited liability company in which they are the only members. As members in this nonprofit, they share capital costs while reducing competition and their own risks.

A **business combination** changes a nonprofit's legal status – combining the functions, assets and liabilities of two (or more) nonprofits. Inevitably, there is a change of control to the surviving board. A business combination can be accomplished in a number of ways:

Formal merger. Nonprofit A and Nonprofit B agree to combine into a new entity, Nonprofit C (surviving corporation). As a result, all of the assets and liabilities of A and B transfer automatically to C, and A and B disappear. Filings must be made with the Secretary of State. Moreover, since C is a new entity, a new tax-exemption recognition must be obtained from the IRS and the N.C. Department of Revenue. (This might also be accomplished by having A merge into B which becomes the surviving entity.)

Transfer of assets. Nonprofit X transfers its assets and liabilities to Nonprofit Y. After the transfer, X ceases operations and dissolves. Y (now expanded) continues to operate. In this way, Y never changes its legal personality, which avoids having to obtain a new tax exemption and generally preserves Y's existing contracts and debt obligations. Structuring the transaction as a transfer may avoid triggering a call of Y's debt, which often happens in a formal merger. A dissolution is also cheaper and simpler than a formal merger.

In any restructuring of a "charitable" or "religious" nonprofit, North Carolina limits who can be merger partners and sometimes even requires that the merger plan be submitted to the Attorney General for that office's consent. Similarly, a "charitable" or "religious" nonprofit that wishes to sell or transfer all or substantially all of its assets must provide the Attorney General with prior notice.

Example

In 1992 the board of trustees of the University of Connecticut at Bridgeport agreed to have control of the college pass to the Professors World Peace Academy, an entity controlled by Korean cultist Sun Young Moon. Various alumni, faculty and trustees asked a Connecticut court to annul the takeover. The Connecticut Supreme Court ruled that since the attorney general had not intervened on behalf of the public to oppose the takeover, the plaintiffs lacked standing to challenge the board's actions.

Even when restructuring makes sense, there may be other considerations – nonprofit leaders and executives may not want to give up autonomy, or the board might have a clinging sense of ownership. Nonprofit boards and staff should be aware of these emotional (and understandable) concerns and be willing to listen and accommodate.

Liabilities in a restructuring. In for-profit corporations, which have seen a significant increase in takeover activity in the last 20 years, courts have developed a deep body of law. This has not happened for nonprofits – creating uncertainty about the standards that apply when the board fundamentally restructures the nonprofit. In one respect, however, North Carolina law is clear. Nonprofit board members can become personally liable if they vote or assent to distributions in liquidation without discharging or providing for known or reasonably known obligations of the corporation.

Part 2
The Nonprofit Board - Some Essentials

This part describes:
- the selection of board members for nonprofit boards;
- the composition of nonprofit boards;
- the functions of nonprofit boards (and committees); and
- the conduct of nonprofit board meetings.

As a board member, you should understand how board membership is decided, why you are on the board, and how nonprofit boards function generally. You should be aware of your nonprofit's mission and purposes, the allocation of powers between the board, its committees and the nonprofit's executives, and how executive compensation is set. You should also know how board meetings are scheduled, conducted, and documented.

2.1 How are nonprofit board members chosen?

How nonprofit board members are chosen depends on the type of nonprofit corporation:

Membership nonprofits. In a nonprofit membership corporation, the members with voting rights usually elect board members just as shareholders in a for-profit corporation elect directors. Usually, the election is conducted at an annual meeting, according to procedures specified in the bylaws. By law, the members must receive notice before the meeting. At the meeting, a slate of candidates is presented, and those candidates with the most votes are elected. Many membership nonprofits also conduct elections by mail ballots.

Non-membership nonprofits. Many nonprofits do not have members. Usually, these boards are "self-perpetuating" – that is, incumbent board members elect or re-elect those who serve as board members. Nomination and election procedures are usually specified in the bylaws.

"Good Practices" Pointer

If the nonprofit has voting members, it is essential to have an accurate and current list of members. (This is one of the biggest compliance problems in membership nonprofits!) This list should be updated on a regular basis, at least annually when notice goes out for the election of board members. The list should include *only members with voting rights*, as described in the corporation's articles and bylaws. Be careful that the list does not include simply donors or friends, people who technically have no voting authority.

Period of service. In most cases, board members are elected for a fixed period of service specified in the articles of incorporation or in the bylaws. Often, board members serve two- or three-year terms. The board terms can be staggered so that only one-half or one-third of the board is up for election each year. This creates greater continuity on the board.

"Good Practices" Pointer

New board members should receive a binder with copies of the following:

- basic corporate documents (articles of incorporation, bylaws and mission statement)
- minutes of the board for the prior year
- an explanation or summary of the nonprofit's "directors and officers" liability insurance policy (if there is none, an explanation of why)
- financial reports for the prior year (including Form 990)
- a list of current board members and key executives (including contact and biographical information);
- a list of committees and committee members
- information about the corporation's outside accountants and lawyers

Annual orientations for incoming board members are highly recommended. At a minimum, the new board member should have a conversation with the nonprofit's board chair and its chief executive about current issues and plans, as well as long-range objectives.

Number of board members. The number of board members should be stated in the bylaws. Sometimes the number is fixed. Other times the number can be set by the board, subject to a minimum and maximum. In either case, the board should be sure the correct number of board members is serving. North Carolina law permits a one-person board, and the single director's act constitutes board action. *Principles & Practices for Nonprofit Excellence: A Self-Help Tool for Organizational Effectiveness*, a project of the N.C. Center *for* Nonprofits, recommends no fewer than 5-7 board members.

Special categories of board members. Board members may be on the board because of another position they hold – in that case, they are called *ex officio* board members. For example, the articles of incorporation or bylaws may specify that the corporation's executive director is automatically a director, by reason of his or her office. Does an *ex officio* board member have full director rights, including the right to vote? Or is the *ex officio* board member just an honorary or political position? That depends. The bylaws should define the rights and duties of any *ex officio* board member.

Sometimes people designated as "board members" are not true board members, but instead attend board meetings in a special non-voting capacity. For example, "honorary," "life," or "emeritus" board members typically do not have voting rights, do not count toward a quorum at meetings, and do not count toward the minimum or maximum number of directors on the board. Instead, they are invited to attend meetings and may be permitted to participate in meeting discussions and even to state how they might vote, if they could. The bylaws should specify the rights of these non-voting board members.

Board members as legal counsel. Sometimes the nonprofit will want to seek legal counsel, including from a lawyer who serves on the board. Nonprofits should recognize that retaining a board member as legal counsel can create conflicts of interest and reduce counsel's independence and objectivity. A board member who acts as legal counsel may also jeopardize the privileges of the attorney-client relationship (such as confidentiality) when the board member wears both the hat of attorney and of board member.

"Good Practices" Pointer

Sometimes the board will open its meetings to non-board members, such as honorary board members, special presenters, or even community members. The board should realize that the presence of non-board members at the meeting may jeopardize the *attorney-client privilege* if the board consults with legal counsel about matters affecting the nonprofit. If there will be discussions with legal counsel, it may be a good idea to ask any non-board members (and even staff without an interest in the matter) to leave the meeting and to hold the meeting in executive session. This also applies to confidential documents meant as communications between the nonprofit's attorney and the board.

Removal of board members. Board members may be removed in accordance with statutory procedures, or in accordance with procedures set out in the bylaws that do not conflict with the statute. The statutory procedures vary depending on whether board members are elected by members or the board. For example, directors elected by the board may be removed by a majority of directors then in office – subject to any provision requiring a greater vote or other limitation in the articles of incorporation or the bylaws.

The articles of incorporation or bylaws sometimes specify that a board member who misses a specified number of board (or committee) meetings is removed from the board automatically. In these circumstances, however, it may be advisable for the board chair to ask a board member who has failed in his or her duties or attendance to resign. The resignation should be in writing and directed to the president/chair of the board.

Compensation of board members. Nonprofit board members normally serve without compensation. Although North Carolina law allows for director pay, most nonprofits only reimburse board members for necessary expenses (such as travel to board meetings and lodging). This avoids questions of improper personal benefits. Also, the statutory immunity available to volunteer board members is lost if the board member is paid for service on the board.

Board members of nonprofit subsidiaries. Sometimes nonprofit corporations will allocate nonprofit operations and activities among subsidiaries – that is, separate nonprofit corporations whose board is elected or appointed entirely by the parent nonprofit. For example, a nonprofit hospital might decide to place its air ambulance service in a separate nonprofit corporation. To maintain control, the air ambulance board members would be chosen by the nonprofit hospital, typically in its capacity as sole member.

2.2 Who can (and should) be on the board?

Director qualifications. The articles of incorporation or bylaws may specify director qualifications. Board members of a North Carolina nonprofit need not be residents of the state or members if the nonprofit is a membership corporation, unless the articles of incorporation or bylaws require it.

Type of director. Even if a person satisfies the formal qualifications (if any) for a board member, choosing the right persons for the board is critical to your nonprofit's success. The answer may depend on the nonprofit's stage of life. Depending on where a nonprofit is in its organizational development, the need for different types of board members who bring the appropriate expertise will change. The seven stages of nonprofit life cycles include the idea, start-up, growth, maturity, decline, turnaround, and terminal stages. An excellent resource is *Nonprofit Lifecycles: Stage-Based Wisdom for Nonprofit Capacity* by Susan Kenny Stevens.

Diversity. Board members with diverse backgrounds, expertise, and perspectives can make points and ask questions that the rest of the board has never considered. Diversity includes characteristics like race, ethnicity, and gender, but also encompasses other factors as well. A nonprofit board should include at least one individual with knowledge of accounting and other financial topics. Nonprofits may wish to include individuals with legal or business expertise, and they may seek representation from the private, public, and nonprofit sectors. Individuals who have been served by the nonprofit, or other stakeholders of the nonprofit, can often make unique and important contributions to the board. Finally, the presence of diverse philosophical perspectives can challenge shared assumptions and stimulate new approaches to problems.

2.3 What are the functions of a nonprofit board?

Knowing the nonprofit's purposes. You should know your nonprofit's purposes and the constituencies it serves. That is, what does the nonprofit do and for whom?

You can find a general statement of the nonprofit's purposes in the *articles of incorporation* and the *bylaws*. In addition, the organization should have a *mission statement* to provide clarity and focus. You should be familiar with these documents.

"Good Practices" Pointer

If there is no document that clearly states the nonprofit's purposes, you should urge that one be created. It should summarize the organization's reasons for existence in a few focused sentences. This helps give direction to the nonprofit and avoids misunderstandings about the purpose of the collective enterprise. Brief mission statements for specific projects (consistent with the nonprofit's main mission) also are useful to identify a consensus of what the project is meant to accomplish and for whom.

What should be in a mission statement? That depends. For fixed-purpose nonprofits (like a homeless shelter), the mission statement should be consistent with its articles of incorporation and specify who is

being served and in what ways. For broader-purpose nonprofits (like local community organizations) the mission statement identifies the general constituency being served and the kinds of services being offered. A mission statement also serves as a promotional tool to be used with the organization's many stakeholders.

"Good Practices" Pointer

Mission statements, like nonprofits themselves, should not remain static. *Principles & Practices for Nonprofit Excellence: A Self-Help Tool for Organizational Effectiveness* recommends that "as part of ongoing planning and with input provided by the organization's stakeholders, the mission statement should be evaluated periodically by the board against the organization's current activities."

Board's authority over nonprofit. According to North Carolina law, "all corporate powers shall be exercised by or under the authority of, and the affairs of the corporation managed under the direction of, its board of directors." This means that individual board members do not have the power to act for the corporation (unless the nonprofit has only one board member). The board's power is the cornerstone of corporate law.

The board is not expected to operate the nonprofit's day-to-day operations. These tasks are delegated to nonprofit executives, staff, and sometimes outside agents. The board is responsible for overseeing these persons and their activities.

As a general rule, nonprofit boards must meet in order to act. To encourage collegial decision-making, North Carolina law generally requires that board decisions be made during board meetings. Meetings can be conducted in person or through electronic means, so long as all "present" can simultaneously hear each other during the meeting – as on a telephone conference call. The one exception to the meeting rule is that board action can be approved by the board members' *unanimous* written consent, unless the articles of incorporation or bylaws do not permit this.

"Good Practices" Pointer

As a board member, you should feel free to contact the nonprofit's chief executive if you have questions or concerns. It is inappropriate, however, to undercut his or her authority by contacting other staff members about nonprofit operations. If you volunteer with the nonprofit, you should see yourself as no different (or more important) than any other volunteer.

Rights to information. To carry out their functions, board members are entitled to information about the nonprofit. Generally, nonprofit board members have a right to inspect, for reasonable purposes and at reasonable intervals, the corporation's books and records. The board member may ask the nonprofit's chief executive to have the data compiled. The board may give information about the nonprofit to an accountant or attorney hired to provide professional advice, but should do so with the knowledge of the chief staff executive (unless there is reason to suspect financial or other impropriety).

Board committees. Nonprofit boards frequently do their work through committees that are formed by the board. The purposes, powers, and limitations of any committee should be stated in the bylaws or board resolution. Under North Carolina law, a board committee must have at least two members to have the authority of the board on any matter. There are three kinds of board committees:

Special committees. These can be advisory or created with limited powers for a specific purpose. For example, a special committee (sometimes called *ad hoc*) might be asked to recommend whether to rent new office space, to plan a special year-end gala, or to represent the nonprofit before the state housing authority.

Standing committees. These are committees that the board uses to allocate and discharge its functions. Permanent standing committees (such as Executive, Finance, Human Resources, Investment, Membership, Nomination, Planning, and Audit) should be authorized in the bylaws. Especially important are the Finance, Nomination, and Audit Committees.

The **Nomination (or Board Development) Committee** may be charged with recommending new or continuing board members, recommending the midterm removal of board members in unusual circumstances, suggesting expansion and contraction of the board, and recommending committee composition.

The **Finance Committee** is often responsible for monitoring the cash flow and overall financial health of the nonprofit, including working with staff to prepare an annual budget for board approval and developing financial plans for the future. the Finance Committee should be composed of non-employee board members who have the appropriate expertise and independence, but should include the CEO/ED and/or the chief financial staff member.

The **Audit Committee** is especially important, particularly in the wake of several widely-publicized accounting scandals in recent years. The Audit Committee oversees the accounting and auditing practices of the nonprofit. It is responsible for retaining and consulting with outside auditors, reviewing the audit report and other financial statements, and approving internal procedures and controls. This committee should be composed solely of non-management directors and should be independent of the Finance Committee.

The **Investment Committee** (particularly useful for nonprofits with endowments or large cash reserves) is often charged with overseeing the nonprofit's funds and ensuring that the organization is in compliance with applicable legal standards governing the management of the corporation's funds.

Rotating new members into these committees protects against complacency.

The **Executive Committee** often includes all officers and sometimes the chairs of standing committees, as well as the CEO/ED. The Executive Committee generally has the most of the powers of the board to act between board meetings. By law, the Executive Committee cannot be delegated certain significant matters such as the election of officers, appointment of committee members (even to fill vacancies), distribution of assets, dissolution or merger, sale of substantially all of the assets, or amendments or repeal of the corporate articles of

incorporation or bylaws. The board should be informed of any actions taken by the Executive Committee since the last board meeting.

Committee members, particularly if the board has delegated power to the committee, generally have the same rights as board members to notices of meetings, quorum requirements, access to information, and a right to record dissent. The directorial duties of care, loyalty and obedience (discussed in Part 3) apply also to committee members. Committees should keep minutes of their meetings and provide reports to the board as requested.

"Good Practices" Pointer

To be effective, committees should be small (3-7 members). This assures that committee members take their role seriously. Committee membership should not be a political "perk," but should be based on a person's ability and willingness to carry out the committee's functions. Every year, the board chair should review the committee structure to identify which committees are authorized and functioning, whether they are operating within their prescribed powers, whether they are making proper reports, and whether there are any functions that should be delegated to other committees or returned to the board.

Committees may include non-board members, but in such a case the committee's powers should only be advisory. To have power to make decisions that bind the nonprofit, the committee should be composed only of board members.

Sometimes nonprofits will form advisory boards (or boards of advisors) to provide the board with input from the communities they represent. Advisory boards may make recommendations that will be attributed to the nonprofit. Their membership and purposes should be chosen with care.

Financial oversitght. Although standing committees may have specific responsibilities relating to the nonprofit's finances, every board member should be familiar with the financial health of the organization. Board members should review and seek to understand the nonprofit's balance sheet, income statement, statement of cash flows, and other financial documents. Financial statements are often based on a set of assumptions, including those involving future revenues and expenses, and board members should ensure that those assumptions are reasonable.

Setting executive compensation. One of the most important – and sensitive – functions of the board is setting compensation for the nonprofit's top executive. Finding the right balance between fairly compensating the executive for his or her services and being a steward of the nonprofit's finances is not easy. Many nonprofits, particularly larger ones, have a Personnel (or Human Resources) Committee that receives and evaluates the chief executive's performance, reviews comparative data, and recommends compensation packages to the board. The entire board then reviews the recommendation and approves (or modifies) the final packages.

Example

Executive compensation of nonprofit executives has been controversial. Pay should be related to performance (as measured by stated goals) and based on comparisons of similar executives in other nonprofits.

In 1992, the President of United Way of America, William Aramony, was forced to resign after reports that he had misused the nonprofit's money to pay for vacations, luxury apartments, and other benefits for himself and his teen-age girlfriend. His earnings of $463,000 in salary and benefits took many by surprise, including state prosecutors. Mr. Aramony was eventually convicted on 25 felony counts of looting United Way of America to subsidize his high-flying lifestyle that included lavish European vacations and gambling trips. He was sentenced to seven years in prison.

In response to this and other selected stories of compensation abuse in nonprofits, Congress enacted a law in 1996 that allows the IRS to assess a penalty against nonprofit executives who receive excessive salaries and benefits, as well as against the nonprofit board members who approved the arrangements. These "intermediate sanctions" are meant to give the IRS more oversight of nonprofit pay. Before the new law, the IRS could only revoke the tax-exempt status of the organization – a somewhat ill-suited tool.

Discussions and recommendations on compensation are generally confidential. The CEO/ED is often responsible for working within a board-approved budget to set salaries for the nonprofit's staff. This is a responsibility of the CEO, who may seek advice of the board. The board should resist the temptation to micro-manage this function. It is reasonable for the board to estimate staff salary ranges and direct the CEO/ED to work within these limits.

Publicity. Public statements – such as annual reports, brochures, and press releases – are an important way for the nonprofit to maintain a public presence. Public statements on controversial subjects not only raise public-relations issues, but may create legal liability if they contain misrepresentations or impugn reputations.

"Good Practices" Pointer

Public statements should be reviewed with care. The legal and practical implications of public statements on employees, volunteers, and donors should be considered. The nonprofit should have a procedure that specifies those officers responsible for approving public statements, as wells as their content and timing.

Fundraising. Raising money is one of the primary tasks of a nonprofit board of directors. Board members should be actively involved in the fundraising process, working in collaboration with staff. All board members should make a financial contribution, however small, to the nonprofit. There are other

ways for board members to contribute to fundraising efforts, such as identifying prospective donors, making introductions, or writing letters or making phone calls to acknowledge gifts. Fundraising efforts also require board members to fulfill an oversight function, ensuring that money is raised in an ethical manner and in compliance with laws regulating fundraising activities (which 46 states, including North Carolina, have passed).

No one board member model. The life of a nonprofit is always changing – which usually is a good sign. Your role as a board member may depend on the nonprofit's stage of development. For a young, emerging nonprofit, you may be expected to perform particular tasks or to advise the nonprofit's leader. If the nonprofit is more mature, you will probably take on an oversight and policy role. In a large nonprofit, your role may be institutionalized. That is, the job of nonprofit board member comes in many flavors and sizes.

2.4 How does the board conduct meetings?

Nonprofit boards act at meetings. In fact, board actions taken outside of meetings are invalid, unless all the board members have given their written consent. You should know how board meetings are scheduled, conducted, and documented.

Scheduling of meetings. There is no legal requirement on how often the board must meet. But the board, whether large or small, should meet regularly. For many boards, the meeting schedule may be fixed at the beginning of the year so board members can place the meetings on their calendars. For other boards, board members may decide at each board meeting when to hold the next meeting. In either situation, a regular meeting schedule (every quarter or every month) is important for the board to exercise its functions.

"Good Practices" Pointer

Not only are regularly scheduled meetings important, but there should be regularity in the *written* information that the board receives. This includes an agenda for the board meeting, minutes of the last meeting, any resolutions to be proposed, financial reports, committee reports, program reports, and so on. This information should go to all board members. The bylaws may specify a minimum amount of time prior to the meeting that board members should receive the information. Good practices recommend at least two weeks so that board members will have time to review the materials. As a director, you'll want to make sure you do.

All board members are entitled to advance notice of all board meetings. Notice for regular meetings can be contained in a schedule of meetings for the year. Notice of special meetings must be sent at least five days before the meeting, unless the articles of incorporation or bylaws specify a different period. Under North Carolina law, special meetings can be called by the board chair or president, or at least 20% of the current directors, unless the articles or bylaws provide otherwise.

Meeting rule. Board members must be present in person at board meetings. You cannot give your

proxy or appoint another person (even another director) to represent you. Why is this? The idea is that the board considers and makes decisions as a group. It is more than the sum of its individual parts. Each board member, including you, is on the board to contribute unique perspectives and values, thus strengthening collegial decision-making. Moreover, you cannot delegate your fiduciary duties to another person.

"Good Practices" Pointer

If not in the bylaws already, the board should consider adding a policy that board members are expected to attend a specified percentage of meetings. The bylaws can specify that failure to attend the requisite number of board or committee meetings would permit, or even require, the removal of the director. The board might consider offering an "honorary" board membership to valued persons who have difficulty regularly attending meetings.

Can board members be "present" by telephone or other electronic means? North Carolina law allows this so long as all board members participating may "simultaneously hear" each other during the meeting. For there to be a valid board meeting, there must be a quorum present equal to at least a majority of the board members in office. (The articles and bylaws can authorize a smaller quorum, but it must be at least one-third of the board members in office.) In addition, there must be a quorum present at the time any board action is taken for the action to be valid.

There is one exception to the meeting rule. In some circumstances, it may be necessary or convenient for the board to take an action without a formal meeting. North Carolina law allows board members to act without a meeting, so long as each director consents to the action in writing. Unanimous written consent might be used when time is of the essence and all the board members cannot be brought together, or for routine matters when discussion is not needed. It is good practice for the board at its next regular meeting to ratify any action that had been taken by unanimous written consent.

Rules of procedure (and minutes). There is no mandated procedure for conducting nonprofit board meetings (although many nonprofits provide in their bylaws that meetings are governed by the then-current version of Robert's Rules of Order), except that each director has one vote, and the affirmative vote of at least a majority of the board members present at the meeting is the minimum necessary for most board actions. The articles of incorporation or bylaws may require a higher threshold, or "supermajority." Moreover, the nonprofit corporations statute requires a higher threshold for certain specific types of actions – for example, an amendment to the bylaws must be approved by a majority of the individuals *then serving as directors*, not just a majority at the meeting. The board may adopt whatever rules are appropriate to its size and membership. Nonetheless, there should be a standard agenda and some formality in dealing with important matters. It is the role of the board chair/president to conduct the meeting.

"Good Practices" Pointer

You should speak your mind at meetings, but be courteous and civil. Communicating false and harmful things about others could make you liable for defamation. North Carolina provides a "qualified privilege" for nonprofit board members, so long as the board members' communications are made in good faith on a subject appropriate to their role in the nonprofit and only to others with similar roles. This means you can share information about an employee, volunteer, or donor with others who have a need to know, provided you do not know the information is false and you believe that sharing the information is useful to the organization.

If you disagree with an action proposed at a meeting, you should state your disagreement and vote against the action. If you do not, North Carolina law deems your silence to be assent. If you disagree with an action, you should have your negative vote recorded or your dissent entered in the minutes of the meeting. You can also file a written dissent with the meeting's secretary before adjournment or forward it by registered mail to the secretary immediately after adjournment.

For each meeting, there should be a secretary who will be responsible for preparing minutes of the meeting. Usually, this will be the person holding the office of secretary, but it need not be. Important actions should be presented as a formal resolution and the vote recorded in the minutes.

"Good Practices" Pointer

The minutes of each meeting should –

- state the date and location of the meeting, indicate whether the meeting is regular or special, and describe how notice of the meeting was given
- list the board members and others present at the meeting, including a note of any late arrivals or early departures
- summarize in chronological order the matters discussed, with headings for easy reference (such as "Approval of minutes")
- state clearly any matters presented for board approval, and the specific action taken by the board (generally the vote count need not be recorded);
- note specific votes *against* board action, whenever a director asks that her abstention or dissent be recorded
- refer to any documents presented at the meeting, with significant documents attached to the minutes

The minutes of every board meeting (or meeting of the executive committee exercising board powers) should be prepared and made available to the board for approval at its next meeting. The minutes should then be kept in a "minutes binder." As a board member you are entitled, on request, to receive and review minutes of past meetings.

Open meetings. Generally, the board may decide whether to open its meetings to people other than board members. This means that these individuals may attend meetings only at board invitation. Sometimes there may be specific obligations to have an open meeting. This may be true if the nonprofit receives public monies and is subject to government "sunshine laws," which require certain meetings be open to the public. This may also be true in some membership corporations whose bylaws require that meetings be open to members.

Part 3
The Duties and Liabilities of Nonprofit Board Members – Take Note

This part describes:
- the basis of legal liabilities for nonprofit board members
- the nature of board members' "fiduciary duties"
- the enforcement of legal liabilities against nonprofit board members
- the protections against individual board member liability

Board member liability is an important matter and one that should give any nonprofit board member pause. You should understand how nonprofit board members might become personally liable. You should be familiar with your fiduciary duties and how to carry them out, as well as how you might become legally liable for breaching your duties. You should know what protections are available to you and make sure your nonprofit has these in place.

3.1 How might a nonprofit board member become liable?

Nonprofit board members may become liable as a result of their corporate role in three ways:

Liability to the nonprofit corporation (or person suing on its behalf). Board members may be liable for breaching their corporate or fiduciary duties, which are enforceable in a lawsuit brought by the nonprofit corporation or someone suing on its behalf – often a member or another key stakeholder.

Liability for corporate harm. Board members may be liable for having participated in a corporate decision that directly harms somebody, such as negligently authorizing a dangerous policy that resulted in injuries at a day care center.

Liability for violating statutory requirements. Board members may be directly liable for making decisions or taking actions that violate statutory provisions dealing with such matters as environmental protection, tax compliance, or antitrust law.

3.2 What are a nonprofit board member's fiduciary duties?

Fiduciary duties are at the core of the American corporation, including nonprofits. As a nonprofit board member, you have duties to the corporation and its stakeholders. Some of these duties are legally enforceable in court, and they create the potential for personal liability. Some of the fiduciary duties are merely aspirational and are not enforceable in court, but failing to comply with them disserves the nonprofit and can be the basis for your not continuing as a board member.

There are three fiduciary duties. The *duty of care* describes the attention and judgment you are expected to

exercise in performing your board member functions. The *duty of loyalty* arises when you or another board member has a personal interest that conflicts with the nonprofit's interests. The *duty of obedience* requires board members to comply with the nonprofit's governing principles as contained in its corporate documents.

Duty of care. Under North Carolina law, board members must discharge their duties with "the care an ordinarily prudent person in a like position would exercise under similar circumstances." What does this mean? Here are some guidelines:

You should attend board meetings. Board members act as a group, and your attendance at board and committee meetings is important. Even if you perform other tasks for the nonprofit like soliciting funds or participating in a specific program, repeated absences from board meetings shows indifference and may violate your duty of care.

You should become informed. You should read the information presented to you before and at meetings. You should be curious. Generally this information will come from the nonprofit's staff, and you must decide whether it is sufficient. If not, you should request additional information. If you are not adequately informed, you may violate your duty of care.

You can rely on trustworthy information. You are expected to be familiar with the financial, legal, and operational issues facing the nonprofit, but you are not expected to be an expert. By law, you may rely on "reports, communications and information received from another board member, a committee or from any officer employee or agent" – if you believe the source to be reliable and competent. If you know something that contradicts this information, or if your reliance is otherwise unreasonable, you may be held to have violated your duty of care.

You should exercise independent judgment. Group-think is a danger in any decision-making body. As a board member, you should be objective and independent. Your responsibilities are to the nonprofit as a whole, not any particular person (such as the nonprofit's executive director) or any particular constituency.

You should monitor the nonprofit's activities. The board delegates the conduct of the nonprofit's day-to-day operations to the nonprofit CEO/ED, staff, and sometimes outside agents. You are responsible for overseeing these operations. You should be inquisitive. You should insist on regular reports, and you should act if you believe there is mismanagement, illegality or other improprieties.

This describes what you should do. But many of these duties of care are aspirational and not enforceable in court. Under the *business judgment rule*, a nonprofit director who exercises good faith judgment will usually be protected from liability to the corporation and its members. This is true even if the corporate action turns out to be unwise or unsuccessful. (This judicial policy not to "second guess" nonprofit board members has been recognized in other states, but no North Carolina court has yet had an opportunity to apply it here.) The business judgment rule does not apply in cases of criminal activity, fraud or willful misconduct.

"Good Practices" Pointer

Some courts have said that the business judgment rule depends on board members making *informed* decisions. To get the protection of the rule, well-advised boards insist on receiving written reports and professional advice before making important decisions. This creates a record of responsible, attentive decision-making.

Your duty of oversight includes ensuring the nonprofit complies with the law – such as health and safety standards, mandatory insurance coverage, and tax reporting rules. If you believe the nonprofit is not in compliance or is engaged in illegal activities, you should point this out to the nonprofit's chief executive and demand an investigation and action. If this does not happen, you should bring the issue to the full board. If the board fails to act, you should have your dissent recorded in the minutes and you should consider resigning from the board.

"Good Practices" Pointer

If you become aware of illegal activity that is not corrected, you may have legal obligations to disclose the matter to government authorities. You should consult an attorney on your obligations and your options.

In addition to monitoring for legal compliance, you are also obligated to monitor for improper management activities. If you suspect activities such as embezzlement of nonprofit funds, financial misreporting, undisclosed self-dealing transactions, unauthorized activities, or other improper behavior by the nonprofit's CEO/ED or staff (or other board members), you should bring the matter to the chief executive or the full board. This will often present an uncomfortable situation, but your role as "watchdog" for the nonprofit is one of the most important you have. If the matter is not resolved, you should consider resigning.

Nonprofits, particularly private foundations, often oversee the investment and disbursement of large amounts of money. Under what standard are the nonprofit's investment policies judged? Under North Carolina law, as of 2007, educational, religious, and charitable organizations may:

- invest in any property deemed advisable by the board of directors, whether or not it produces a current return
- retain contributed property for as long as the board of directors deems advisable
- include contributed funds in any pooled or common fund maintained by the nonprofit corporation
- invest all or part of the funds in any pooled or common fund available for investment (such as mutual funds) maintained by another entity, in which funds are co-mingled and investment determinations are made by persons other than the board of directors of the nonprofit corporation.

The board of directors has significant discretion to delegate management and oversight of the nonprofit's investments. Under North Carolina law, the board may:

- delegate to its committees, officers, employees, or agents the authority to act in place of the board of directors in investment of contributed funds
- contract with independent investment advisors, investment counsel or managers, banks, or trust companies, with regard to management and investment of contributed funds
- authorize the payment of reasonable compensation for investment advisory or management services.

"Good Practices" Pointer

In making investment management decisions (including delegation), the board should consider the nonprofit's long- and short-term needs in carrying out its purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.

In addition, the nonprofit's investment authority and the board's exercise of discretion with respect to funds are both subject to any restrictions in a gift instrument under which the nonprofit received those funds.

Duty of loyalty. As a nonprofit director, you must act in the best interests of the nonprofit – not for your own advantage. The *duty of loyalty* arises in a number of situations:

Self-dealing transactions. If the nonprofit enters into a transaction (such as a contract or lease) in which you have an interest, the nonprofit's interests come first. (In some nonprofits, such as private foundations, such a transaction is absolutely prohibited.) In most nonprofits, conflict-of-interest transactions are not prohibited so long as you disclose your interest so that other disinterested board members can pass on the fairness of the transaction to the nonprofit. Under North Carolina law, you are deemed to have an interest in a transaction if the other party to the transaction is a related person or a business in which you have a position or financial interest. For example, if you (or a related person) supplies goods to the nonprofit, the conflict of interest carries the risk that the nonprofit may be overcharged. You have a duty to put the nonprofit's interests first and disclose your conflict. This is so even if you personally receive no monetary or other tangible benefit in the transaction.

Example

Consider these conflicts: (1) Director A holds a significant investment in Furniture Inc. which sells office furniture to the nonprofit. (2) Director A's spouse applies to become the nonprofit's head of personnel. (3) Director A is an accountant who works in an accounting firm, which offers to provide financial advice to the nonprofit.

In each case, there is a conflict between A's personal, financial, or professional allegiance and the interests of the nonprofit.

Corporate opportunities. If you become aware of a business transaction or other opportunity offered by an outside party that you believe the nonprofit would be interested in taking for itself – such as office space that the nonprofit has been looking for – you cannot take the opportunity yourself. Instead, you must first offer the opportunity to the nonprofit if it fits within its current or future plans, and disclose your interest. This gives the nonprofit board a chance to take the deal or reject it. Only after disinterested board members have rejected it can you take the outside opportunity for yourself.

Example

Board member B is on the board of the local country club. Landowner Z owns two lots adjacent to the country club's golf course and asks B if the club would want to buy. B purchases the lots without informing the board. This usurps a corporate opportunity, because B received the offer in her status as a board member. B should have disclosed the offer to the board. The nonprofit corporation may be able to treat the lots as having been purchased by B for the nonprofit.

Confidential information. In your role as a board member, you may become aware of nonpublic information whose confidentiality is valuable to the nonprofit – such as the possibility the nonprofit qualifies for a government grant or that the nonprofit's endowment has identified a lucrative investment opportunity. You may not use this information for your own benefit. Only if the board approves your use may you use information that belongs to the nonprofit.

Example

The board of a private university solicits bids for construction of a new library annex. When the bid of Builders Corporation wins, board member C secretly buys stock of Builders Corporation. This use of confidential information to buy stock is a breach of C's duty to the private university – and may also be insider trading, a violation of federal securities laws.

In each situation, notice that the first step is for you to recognize the conflict. This will not always be obvious. Being aware that the nonprofit's interests may conflict with your own requires a special sensitivity and astuteness. Once you recognize the conflict, it is your duty to disclose it. This is so even if you believe the transaction with the nonprofit is on fair terms, or the opportunity is one the nonprofit would not want, or the information is not valuable.

"Good Practices" Pointer

Many nonprofits have a policy statement about conflicts of interest, which board members sign on joining the board. Typically, the statement calls on board members to disclose any "dual" interest and not to vote or use any influence in the matter. The statement describes particular conflicts that might arise in the nonprofit – for example, in an art museum, board members who collect or deal in art for themselves or who use the art museum's facilities for personal events. The board should be sure that the nonprofit's policy statement is readable and used consistently. If not, it will only serve as evidence in litigation of what the board failed to do.

Under North Carolina law, a majority of disinterested board members (not less than two) can approve a conflict transaction if they believe the transaction is in the nonprofit's best interests. If you have a conflict, can you participate in board deliberations or any vote concerning the matter? North Carolina law says that your presence or vote does not affect the validity of the board's action. But to bolster the appearance of disinterested approval, once you have identified your interest and described your relationship to the transaction, you should leave that part of a meeting at which the matter is discussed. This will not affect the meeting's quorum, which is deemed to be satisfied if a majority of *disinterested* board members approve the transaction.

"Good Practices" Pointer

If the board passes on a board member's conflict of interest, it is imperative that the minutes of the meeting reflect the interested director's disclosure and the board's response. If the board approves a transaction in which the board member has an interest, the nonprofit may also be required to disclose it to the IRS as a "related party transaction."

In some situations, self-dealing is flatly prohibited – regardless of motives or fairness. For example, the board's responsibility toward endowment funds or employee benefit plans are as a "trustee," which means that self-dealing with these funds is strictly forbidden. Private foundations are expressly prohibited from engaging in self-dealing, and this prohibition is enforced by an excise tax. In addition, under North Carolina statutory law, a nonprofit corporation cannot make loans to a board member, unless the board member is a full time employee and the board (with the interested board member abstaining from voting) approves the loan by majority vote. Board members who approve loans to other board members become personally liable to repay the loan.

What happens if the board becomes aware of a conflict of interest only after approving a transaction or taking other action? The board should re-examine the matter, by seeking appropriate disclosure from the interested board member and then creating a record of its scrutiny. The board may be within its rights to reverse its prior approval and cancel the transaction.

"Good Practices" Pointer

In a membership nonprofit, the board can ask the members to ratify the board's approval of a conflict of interest transaction. If so, the notice of the members' meeting must describe this matter.

Duty of obedience. The board must be true to the organization's purposes and goals, as stated in the articles of incorporation and bylaws. In addition, many nonprofits (unlike business corporations) are charged with carrying out specific instructions. They may come from the terms of gifts or bequests, or from purpose statements describing how the nonprofit's funds are to be used. As a board member, you must abide by these instructions.

Example

In 1975, Beryl Buck bequeathed $10 million worth of oil company stock to a trust for the benefit of Marin County, California, one of the richest counties in the country. Ten years later, when the stock's value had risen to $400 million, the trustee sought court approval to spend some of the income to benefit the San Francisco Bay area. The California attorney general opposed on the ground that the original restriction was still possible to effectuate. The court agreed and denied the trustee's request.

Do you have a duty of obedience to represent a particular constituency if they chose you for the board? For example, perhaps you are on the board of a statewide environmental association and you represent environmental groups in the eastern region. Remember that the law imposes common responsibilities and powers on all board members. Although you can bring your constituency's concerns and perspectives to the attention of the board, your duty is to advance the nonprofit's mission and overall interests, not the interests of the sub-group that elected you.

The Sarbanes-Oxley Act. The passage of the federal Sarbanes-Oxley Act in 2003 has implications for nonprofit board members' oversight duties. Although the law focuses on for-profit corporations, two aspects of the law also apply to nonprofits. First, nonprofits must provide protection for "whistleblowers," individuals (generally staff) who report possible illegal activity on the part of directors, management, or other staff. Many nonprofits have developed whistleblower protection policies. Second, Sarbanes-Oxley makes it illegal to modify, conceal, falsify, or destroy documents to prevent their use in an official proceeding such as litigation or a federal investigation. As a result, nonprofits have begun to craft internal document retention and destruction policies. Samples of these policies are available in the N.C. Center *for* Nonprofits Frequently Asked Questions.

In addition, many nonprofits have taken additional steps ranging from creating separate audit committees to drafting internal codes of ethics. Nonprofit board members should be aware of these developments and ensure that their organization takes reasonable steps to ensure that it meets the highest standards of accountability and integrity. An excellent resource is "The Sarbanes-Oxley Act and Implications for Nonprofit Organizations," published by Independent Sector.

3.3 Who can enforce fiduciary duties?

Board members owe fiduciary duties to the nonprofit corporation. A board member who breaches his or her fiduciary duties may be sued either by the nonprofit corporation or by somebody acting on its behalf.

Suit by the nonprofit corporation. If the board authorizes the lawsuit, the nonprofit corporation can sue directly. Any recovery will be to the corporation.

Example

The North Carolina nonprofit statute specifically imposes liability on board members who approve:

- unlawful distributions of assets in violation of corporate documents
- loans to board members or officers of the nonprofit who are not employees
- distributions in liquidation without discharging all reasonably known debts.

In each case, the board members who voted or assented to the transaction become fully and personally liable for the improper payments.

Suit on behalf of the corporation. If the corporation does not sue, who can sue on its behalf? The answer depends on the type of nonprofit. In a membership nonprofit, members may sue board members much like stockholders may sue board members in a for-profit corporation. A member suit on behalf of the nonprofit is known as a *derivative suit*.

In many nonprofit corporations, there are no members to hold board members accountable. To fill the legal vacuum, North Carolina law authorizes the N.C. Secretary of State to investigate and the N.C. Attorney General to enforce compliance with nonprofit corporate norms. Historically, this authority was meant to ensure that nonprofits were using their funds for proper, specified purposes. Lately, this authority has been used to enforce board members' fiduciary duties. To investigate noncompliance, the Secretary of State is authorized to send written questions to the nonprofit and its board members and officers, who must answer within 30 days. If the answers indicate noncompliance, the Secretary of State can turn the information over to the Attorney General. Although unusual, such suits have become more common as government functions have been shifted to the nonprofit sector.

Example

In the early 1990s the Connecticut attorney general (responding to public complaints) brought a suit to have state hospitals account for $45 million in "free bed trust funds" that had accumulated over the years. Most of the hospitals had assumed they were immune from suit and had devoted the funds to purposes different from those intended by the donors. Eventually, the hospitals agreed to restore the money to an endowment for free care and publicize its availability to needy patients.

Suits by a nonprofit's stakeholders. You might wonder whether donors to the nonprofit can sue board members for misusing contributions. The North Carolina nonprofit corporations statute does not explicitly authorize donors to sue. For a long time, the assumption has been that assets donated to a nonprofit without contractual stipulations are not subject to donors' control. In non-member nonprofits this has meant legal accountability exists only if the Attorney General takes action. Lately, as nonprofits have grown in importance, some courts have questioned this weak system of accountability and have allowed nonprofit constituents of non-religious nonprofits to sue the nonprofit and its board members directly. (Lawsuits involving religious nonprofits are more problematic since they raise constitutional issues of government intrusion, by the court, in religious affairs.)

Example

In Connecticut, a state court permitted a class action brought by students, alumni, and donor representatives against Yale University. The class claimed that funds meant for the Yale Divinity School had been applied to other purposes. On appeal, a state appeals court overturned the decision and said that the students and alumni had no vested interest, and that the donor representatives lacked standing (could not bring the matter to court) because the original donor had not retained the right to sue when the gift was made.

One thing you might notice is that even though nonprofit board members have duties similar to those as directors of for-profit corporations, there are fewer mechanisms of accountability in the nonprofit setting. This is particularly so for a board that chooses its own successors.

What is the future of director liability? Over the last decade, as government has shrunk and the nonprofit sector has filled the void, nonprofit governance has moved to center stage. Should nonprofits continue to be self-regulating, should they become more democratic, should they become more representative? Accountability, more than ever, is an important issue. It is incumbent on board members to promote effective and accountable practices and to advocate for transparency in the nonprofits they serve.

3.4 What protections are there for a director who is sued?

Board members may find protection from personal liability in five different ways, each requiring some planning. In addition, these protections can often be extended to corporate officers and members of advisory boards.

Business judgment rule. Board members are not personally liable for breaching their duty of care if they acted in good faith and exercised informed judgment. This can be shown if the board members reasonably rely on independent advisers or consultants in making their decisions. For important decisions, nonprofit boards should consider seeking (and documenting) outside advice.

In cases involving the duty of loyalty (conflicts of interest), board members should seek outside advice in making their decision to pursue a self-dealing transaction involving a director who has a conflicting interest or to reject a business opportunity brought to the corporation by an interested director. Outside advice and valuations that support the board's decision provide evidence the transaction was fair and that the board could have made the same decision absent the conflict of interest.

Exculpation (limits on liability). North Carolina is among the states that allows nonprofits to limit the liability of board members in lawsuits brought by the corporation or on its behalf. Under this limitation, which must be stated in the articles of incorporation, a director's personal liability for monetary damages can be limited or eliminated in any suit for breach of fiduciary duties. Exculpation does not apply if the board member knowingly acted contrary to the best interests of the nonprofit, received or approved improper loans from the nonprofit, or derived an improper personal financial benefit.

"Good Practices" Pointer

There is a tendency to believe that if you are sued along with the nonprofit or your fellow board members that there should be a joint defense and joint legal representation. This may be a mistake. Your legal position may be different from that of the nonprofit and the other board members. You may be entitled to protection that the nonprofit may want to deny, or you may have been unaware of information that other board members knew. If in doubt, seek your own legal counsel.

An exculpation provision, even if properly added to the articles of incorporation, leaves significant gaps. A director still can be sued and be forced to pay for legal costs to defend himself or herself. The exculpation does not apply to suits by outside parties, particularly by government regulators. Thus, corporate indemnification and "directors and officers" liability insurance remain appropriate tools for protecting board members.

Statutory immunity for nonprofit board members and officers. North Carolina's nonprofit corporations statute provides a special immunity for nonprofit board members and officers. The statute reads:

> "... a person serving as a director or officer of a nonprofit corporation shall be immune individually from civil liability for monetary damages, except to the extent covered by insurance, for any act or failure to act arising out of this service, except where the person:
>
> (1) Is compensated for his services beyond reimbursement for expenses;
> (2) Was not acting within the scope of his official duties;
> (3) Was not acting in good faith;
> (4) Committed gross negligence or willful or wanton misconduct that resulted in the damage or injury;
> (5) Derived an improper personal financial benefit from the transaction;
> (6) Incurred the liability from the operation of a motor vehicle; or
> (7) Is a defendant in an action [for unlawful director loans or improper distribution of assets]."

In some ways, the statute restates the business judgment rule and the exculpation that can be added to the articles. A board member who acts responsibly and in good faith is protected. But sometimes what constitutes proper behavior will not be clear, and a lawsuit can drag on before it becomes clear there was immunity. Further, unfair self-dealing, gross negligence, and approving improper payments are not covered. Notice also the immunity statute does not apply to director liability covered by insurance, including "directors and officers" liability insurance.

Indemnification. Even if a board member becomes liable, North Carolina law allows the nonprofit corporation to indemnify (hold the board member harmless) by paying for the costs of defense and sometimes the costs of any legal judgments or fines. The nonprofit may also pay, in advance, the attorney fees and litigation costs incurred for the board member's defense.

There are two types of indemnification: mandatory and permissive. Indemnification is mandatory (required by law) when board members are wholly successful in their defense of any proceeding where they are parties as a result of being a board member of the nonprofit. Unless this right is limited in the articles of incorporation, the corporation must pay the successful board member for the "reasonable expenses" of the defense.

Example

A nonprofit hospital engages in research that involves the disposal of biohazard material. The state environmental agency brings a lawsuit against the hospital and its board members for the hospital's biohazard disposal practices. After protracted and costly court proceedings, the court rules for the hospital and its board. Individual board members can compel the hospital to pay their defense costs, including attorney fees, as a matter of mandatory indemnification.

Indemnification is permissive (at the discretion of the nonprofit) if payment to the board member is consistent with state statutes and the nonprofit's articles of incorporation and bylaws. The nonprofit must determine that the board member acted in good faith and with a reasonable belief that the his or her actions were in the best interests of the nonprofit. This determination can be made by the board or by

members in a membership nonprofit. If the lawsuit was brought by the nonprofit, permissive indemnification can only cover reasonable litigation expenses. In other lawsuits, permissive indemnification can cover both reasonable litigation expenses and settlement amounts.

Example

In the same example before involving a hospital biohazard disposal, assume the state agency successfully sues to compel the hospital to change its disposal practices. An individual board member who had defended against the suit could request the hospital to indemnify his defense costs and individual fines. This would have to be approved by disinterested board members or hospital members, only on a finding the board member had acted in good faith reasonably believing the challenged practices were in the hospital's best interests. Indemnification need not be approved.

A board member who has been sued can ask the nonprofit to advance legal fees and other litigation expenses. The board member must affirm in writing that he or she believes he or she meets the standard for permissive indemnification (see above) and that the board member undertakes to repay any amounts advanced if he or she is later not entitled to indemnification. The nonprofit must then determine that advancing fees is not precluded.

"Good Practices" Pointer

Many board members insist that indemnification rights, though generally described in the North Carolina's nonprofit corporation statute, be detailed in the corporation's articles or bylaws. The statute allows for this, and a written and detailed indemnification program may avoid questions of interpretation. Moreover, the board members may want to be certain that they will receive the maximum protection permitted by the statute. Absent corporate action, board members are not assured of having defense costs advanced or of having any amount paid to or for them if they are not entirely successful on the merits of the action against them. Also, some board members insist that the nonprofit purchase insurance to fund its indemnification obligations. After all, a duty to indemnify is useless if the nonprofit has no net worth.

"Directors and officers" (D&O) insurance. D&O insurance, according to North Carolina law, can provide greater coverage than the other protections. (Remember that the business judgment rule and exculpation provisions only protect against suits by the nonprofit, and indemnification for liability to outside parties is only permissive.) Serving on a nonprofit board without D&O insurance can be risky – especially if the organization works with vulnerable populations and has employees. If D&O insurance is available at reasonable cost, it often provides some "peace of mind" for board members who agree to serve on a nonprofit board.

"Good Practices" Pointer

The board should have an independent consultant (or legal counsel) review its D&O coverage, deductibles, and exclusions, and then report back to the board. Any application for D&O coverage should be carefully reviewed for accuracy and fairness. The coverage should be updated if new subsidiaries are created or whenever any significant changes are made in the way the nonprofit does its business. It's a good practice to add the names of new directors and officers upon renewal of the coverage.

D&O insurance has two aspects: (1) reimbursement of individual board member's liability to the corporation or outside parties, if the board member is not indemnified; and (2) funding of the corporation's indemnification obligations, if the board member is indemnified. Thus, D&O insurance can cover liability (and settlements) of cases alleging board members' misconduct in performing their functions on the board.

"Good Practices" Pointer

Attorneys who serve on nonprofit boards can get caught between a rock and a hard place with regard to insurance coverage. D&O coverage may not extend to an attorney director who acts as legal counsel, whether paid or volunteer. The attorney's legal malpractice coverage may not cover this service as a director of outside organizations. A specific endorsement should be added to one policy or the other.

D&O policies are indemnity (not liability) policies, which means that the insurer makes payments only after the insured is required to make payments. As a result, the insurer has no obligation to provide legal representation if you are sued. Instead, you must wait for reimbursement once there is a final determination of liability.

D&O policies also have significant exclusions. Pollution and environmental claims are typically excluded, as well as claims involving intentional conduct (employment discrimination claims, defamation actions, securities fraud claims) and payment of fines, penalties and punitive damages.

Most D&O policies are issued on a "claims made" basis – the policy must be in effect when the claim is made, even if the event leading to the claim occurred before. For this reason, new policies sometimes deny coverage for events that happened before the policy started. This means that you may not be covered if you are sued for events that occurred before the policy began or if a lawsuit is brought after the policy ends. Also, it is always important to notify your insurance provider immediately when you think an event could possibly lead to a claim on your D&O policy.

Note on coverage under "umbrella policies." Many individual directors carry their own umbrella or excess liability coverage. If so, *some* policies cover liability (and provide for a defense) arising out of acts or omissions as a board member or officer of a nonprofit corporation, provided the individual receives no compensation other than reimbursement of expenses. You might want to check!

Part 4
Tax Exemptions for Nonprofits - "Need-to-Know" Basics

This part summarizes:
- the federal tax exemptions, particularly the 501(c)(3) exemption for charitable organizations
- keeping 501(c)(3) tax-exempt status
- exemption from state and local taxes
- the disclosure obligations of nonprofits (tax and non-tax obligations)

Contrary to popular belief, not all nonprofit organizations are tax-exempt. As a nonprofit board member, you should have a general understanding of the tax status of your nonprofit. Is it exempt from federal (and state) income tax? From state sales and use tax? From local property tax? Are contributions to the nonprofit tax-deductible?

Besides a general understanding of the nonprofit's tax status, you should know what is required to maintain any exemptions. This part will guide your decision making and help you with your oversight responsibilities of the staff, accountants, and attorneys responsible for the nonprofit's tax status and reporting.

4.1 How does a nonprofit qualify for a 501(c)(3) tax exemption?

The federal Internal Revenue Code specifies various categories of tax-exempt nonprofits. Each category contains restrictions and rules with which the organization must comply to qualify for and maintain tax-exempt status. Only one category, however, entitles its contributors to deduct their gifts – nonprofits that fall under section 501(c)(3) of the Code.

"Good Practices" Pointer

This summary of nonprofit tax law focuses on 501(c)(3) organizations. You should keep in mind that many federal tax rules are subject to exceptions. If there are particular donations or activities that raise doubts about their tax implications, the board should seek professional legal or tax advice.

Federal tax-exempt organizations. Nine major types of nonprofits are exempt from federal income tax:

- Charitable organizations (charitable, religious, educational, scientific, literary, etc.) - 501(c)(3)
- Social welfare organizations (community groups, civic leagues, etc.) - 501(c)(4)
- Labor and agricultural organizations (labor unions, farm bureaus, etc.) - 501(c)(5)

- Business leagues (trade associations, chambers of commerce, real estate boards, etc.) - 501(c)(6)
- Social clubs (hobby clubs, country clubs, etc.) - 501(c)(7)
- Fraternal societies (lodges and similar orders and associations) - 501(c)(8)
- Veterans organizations (posts of past or present members of U.S. armed forces) - 501 (c)(19)
- Employees associations (voluntary employees' benefit associations) - 501(c)(9)
- Political organizations (campaign committees, political parties, and political action committees) - 527.

Which category does your nonprofit fall into? Even if you don't find it on the list above, the nonprofit may still fall within one of the 27 categories of exempt nonprofits – all listed under section 501(c) of the Internal Revenue Code. The IRS has a useful and comprehensive publication entitled *Tax-Exempt Status for Your Organization* that describes filing for tax-exempt status and the types of nonprofit organizations that can qualify. Publication 557 is available on the IRS's website (www.irs.gov/pub/irs-pdf/p557.pdf).

For most types of tax-exempt nonprofits, contributions by donors to the nonprofit are not tax-deductible. Charitable contribution deductions are permitted only for gifts to 501(c)(3) nonprofits. (For some nonprofits such as trade associations, donor payments may be deductible as trade or business expenses.)

Qualification for 501(c)(3) status. To qualify for 501(c)(3) status, the nonprofit must be organized and operated exclusively for charitable, religious, educational, literary or scientific purposes. In addition, the nonprofit may not have earnings that inure to private individuals; it cannot carry on *substantial* activities to influence legislation (although 501(c)(3) nonprofits that aren't private foundations *are* permitted to lobby); and it may not participate *at all* in political campaigns. For this reason, it is important that the corporation's articles of incorporation (and any amendments) state and limit the nonprofit's purposes, activities, use of assets, and disposition of assets on dissolution.

"Good Practices" Pointer

Amending a nonprofit's articles of incorporation or bylaws, or changing the activities of the nonprofit, should be done with caution. Changes that affect the purposes of the nonprofit or that make the nonprofit more politically active risk the nonprofit's tax-exempt status, and may even subject the corporation and its directors to penalties. If in doubt, the board should seek legal or tax advice.

IRS recognition. As a general rule, to obtain 501(c)(3) status, the organization must apply (on Form 1023) for formal IRS recognition. There are two types of organizations that do not have to request an IRS determination: churches (or church-related corporations) and nonprofit corporations with annual gross receipts not more than $5,000. In addition, nonprofits that are part of a larger organization may be covered by a group exemption letter already issued to the main organization.

If the organization is structured as a public charity, it should request IRS determinations that the organization: (1) qualifies as a 501(c)(3) organization; and (2) qualifies as a non-private foundation, thus avoiding various restrictions and excise taxes applicable to "private foundations." To qualify as a public charity, a nonprofit generally must either demonstrate that it regularly receives significant support from the government or the general public or that it is organized and operated in support of another nonprofit.

Nonprofits must file Form 1023 by the end of the 27th month after incorporation for their 501(c)(3) tax-exempt status to apply retroactively to the beginning of their existence.

> **"Good Practices" Pointer**
>
> Obtaining a tax exemption is a long and complicated process. The organization's structure and organizational documents must comply with IRS rules and expectations. If your nonprofit does not have tax-exempt status, it is wise to seek competent legal assistance.

For most other tax-exempt organizations that claim tax-exempt status under a non-501(c)(3) category, application and formal recognition are not required, though often advisable.

Restrictions on 501(c)(3) "private foundations." Private foundations are 501(c)(3) organizations that do not qualify as so-called "public charities." Not being categorized as a "public charity" means the nonprofit is subject to restrictions and taxes applicable to "private foundations," including –

- restrictions on self-dealing between the private foundation and substantial contributors, directors, and trustees, and other "disqualified persons" (whether or not the transaction is "fair" to the nonprofit)
- minimum requirements for distribution of income and principal for charitable purposes (roughly 5% of investment assets annually)
- limits on the ownership interest in another business entity, such as a corporation, LLC or partnership (to prevent the private foundation from becoming a business holding company)
- prohibition on investments that jeopardize the organization's ability to fulfill its charitable purposes and activities
- excise taxes if the private foundation engages in unlawful lobbying or terminates private foundation status.

Failure to comply with the rules applicable to private foundations can result in excise taxes, which can be imposed on the foundation's directors, managers, and substantial contributors, and in cases of self-dealing transaction on "disqualified persons." The idea behind these rules is to prevent wealthy individuals from setting up a foundation that serves their private interests, rather than the purported public interests that warranted giving the tax advantages of 501(c)(3) status.

Unrelated business income. A tax-exempt nonprofit that carries on a trade or business that is "unrelated" to its exempt purpose may be subject to unrelated business income tax (UBIT). If its unrelated business activity is substantial, compared to the nonprofit's exempt activities, the nonprofit may lose its tax exemption.

UBIT generally does not apply to passive income – such as rents, royalties, research income, capital gains, dividends, and interest. Instead, it applies to any trade or business that the nonprofit regularly carries on that is substantially *unrelated* to its exempt purposes. For example, an educational nonprofit that operates an amusement park may incur UBIT. Even though these activities generate income used for educational

purposes, they are still substantially unrelated to the nonprofit's exempt purposes.

There are some important exclusions from UBIT, if either --

- most of the work is done by volunteers
- the business is carried on primarily to benefit the nonprofit's members, students, patients, officers or employees
- the business consists of selling merchandise, substantially all donated
- the business involves distributing token goods in connection with charitable solicitations
- the business is a legal bingo operation, in a state where bingo is not conducted commercially.

Can a nonprofit establish a for-profit, taxable subsidiary to conduct unrelated activities? This may be a good idea, especially if such activities would be substantial and would otherwise jeopardize the corporation's exempt status. Separate incorporation may also be a good idea if the nonprofit wants to limit its risk exposure. Although the subsidiary will be subject to federal corporate income tax, any dividends it pays the parent nonprofit generally will not be subject to UBIT.

"Good Practices" Pointer

Setting up a taxable subsidiary requires careful tax planning. Some decisions will be irrevocable. If the subsidiary transfers property to the nonprofit or liquidates, there may be adverse tax consequences. Make sure the nonprofit is advised by competent legal or tax counsel before adopting this structure.

Comparison of 501(c)(3) organizations to other tax-exempt nonprofits. Here is a description of tax-exempt organizations that share some characteristics with 501(c)(3) organizations. Even if you are director of a 501(c)(3) organization, it is worth knowing about its cousins.

Social welfare 501(c)(4) organizations. A nonprofit corporation operated exclusively for the promotion of social welfare may qualify as a tax-exempt 501(c)(4) organization. The nonprofit must be operated to further the general welfare of a community. Examples include civic associations, volunteer fire companies, or crime prevention groups. A 501(c)(4) cannot conduct a public business in a commercial manner, and any earnings must go exclusively to charitable, educational, or recreational purposes.

One significant disadvantage of a 501(c)(4) organization is that contributions to it are not tax-deductible. But 501(c)(4) status has some advantages: it may serve a smaller constituency, carry out lobbying as a substantial part of its activities, support or oppose political candidates, and avoid the "private foundation" restrictions.

501(c)(6) trade associations. A nonprofit corporation that promotes the general interests of persons with common business interests qualifies for 501(c)(6) tax-exempt status. The nonprofit's purpose must be to benefit an industry or line of business in general, not any particular members. Examples include business leagues, chambers of commerce, professional associations (like the N. C. Bar Association), boards of trade, standard-setting boards, and

professional sports leagues.

When are activities of a 501(c)(6) trade association general rather than individual? For example, a tax-exempt trade association can publish a trade newsletter for the benefit of the industry generally, but could not operate a real estate multiple listing service that benefited members individually. A 501(c)(6) organization can engage in some business activities, so long as it complies with the rules for unrelated business income.

Contributions or dues paid to a 501(c)(6) organization may be deductible as trade or business expenses, unless they are used for political campaigning or lobbying. Contributions to a 501(c)(6) organization are not deductible as charitable contributions.

4.2 How does a 501(c)(3) organization keep its tax-exempt status?

Status as a 501(c)(3) tax-exempt organization provides significant tax benefits, but comes with significant conditions.

Limitations on unrelated business activities. A 501(c)(3) organization cannot conduct substantial business activities unrelated to its exempt purposes. But "nonsubstantial" business activities are permitted. What is substantial? There are no fixed limitations on how much is "too much." Determinations are made on the basis of all the facts and circumstances.

Example

A nonprofit preschool owns and operates a commercial car wash on the side – as a money-making venture. The car wash looks just like another for-profit car wash down the street. The net income that the nonprofit earns from the commercial car wash is subject to UBIT. If the nonprofit makes "too much" income from this unrelated business, the IRS can revoke its tax-exempt status. Among other things, the IRS will consider how much time the nonprofit devotes to this commercial operation.

Limitation on private benefit. A 501(c)(3) organization cannot permit any part of its net earnings to inure to the benefit of a private individual. Besides forbidding dividend checks to individuals, the limitation has more subtle meanings. If a 501(c)(3) organization pays excessive compensation to its executives, the excess is treated as a distribution of profits, not compensation. If a nonprofit buys goods or services from a director (or even a non-insider) at above fair market value, private inurement results to that individual. The same is true if the nonprofit permits persons to use corporate assets, like vehicles or office equipment, for private purposes without paying for their use.

"Good Practices" Pointer

The board's policy statement on conflicts of interest should reflect these tax rules. The statement should point out the possibility of *individual* liability for penalty taxes if there are "excess benefit transactions" – that is, a transaction where the value received by the nonprofit insider is greater than the value received by the nonprofit. For any transaction that might be treated as an "excess benefit transaction," the board should create a checklist that describes the parties, how fair value was calculated, and the board members' vote on the transaction – and these decisions should be recorded in board and/or committee meeting minutes.

Rather than revoking a 501(c)(3) nonprofit's tax-exempt status, the IRS can impose "intermediate sanctions" or penalty taxes on "excess benefit transactions" involving board members, officers, and major donors (or related persons or entities). The taxes are imposed not on the organization, but rather on the individuals involved. The recipient of the excess benefit must pay a 25% penalty tax, and those who knowingly approved the excess benefit must pay a tax equal to 10% of the excess benefits. If the situation is not corrected, the recipient becomes responsible for a 200% tax.

Limitation on lobbying. A 501(c)(3) that isn't a private foundation *can* engage in lobbying, propaganda or attempts to influence legislation – but these activities must an *insubstantial* part of its overall activities. This includes urging people to contact legislators or to attempt to sway public opinion on legislative matters. What is substantial? Under the default rule, the IRS will look at the time, money and effort expended on lobbying. If lobbying activities constitute more than 5% of a charitable organization's activities, they are likely to be considered substantial.

In 1976, Congress created a clearer and more generous rule for nonprofits that engage in significant advocacy. Nonprofits engaged in lobbying can elect under section 501(h) of the Internal Revenue Code to have lobbying expenditures measured solely as a percentage of their total budget. See www.ncnonprofits.org/faq/ elect501h.asp for more information on how to make this election. Penalty taxes are imposed on those responsible for the nonprofit engaging in impermissible lobbying, and the nonprofit's tax exemption could be revoked if it hasn't taken the 501(h) election.

Prohibition on political campaign activities. Political campaign intervention is *strictly* prohibited for 501(c)(3) organizations, no matter how insignificant. The organization jeopardizes its tax-exempt status by participating in a political campaign for or against any candidate for public office. There is an excise tax of 10% of any political expenditures, and there are severe penalties against the nonprofit and even board members if the political activities continue.

Example

In 1991, the IRS settled a claim with the Jimmy Swaggart Ministries arising from that religious organization's endorsement of Pat Robertson in his 1988 presidential campaign. The organization paid $170,000 in taxes and interest, and agreed to a reorganization.

4.3 What are the state and local tax exemptions?

State income tax. North Carolina, unlike other many other states, does not automatically recognize a nonprofit's federal tax status. Instead, the Department of Revenue makes an independent determination of tax-exempt status. Nonetheless, under North Carolina law, an organization exempt from federal income tax is exempt from North Carolina corporate income tax. The state exemption, once granted, applies to both state income and state franchise taxes.

State sales and use tax. Unlike many states, North Carolina does not exempt nonprofits from paying sales and use taxes on their purchases. But some nonprofit organizations are entitled to refunds of sales and use taxes paid in North Carolina. Not all 501(c)(3) nonprofits are eligible for sales and use tax refunds, and in recent years, the N.C. Department of Revenue has rejected the requests for refunds of some nonprofits that it deems aren't serving a sufficiently charitable class.

The refunds are obtainable for sales and use taxes paid on purchases of tangible personal property used in carrying out the nonprofit's work. These purchases include purchases by contractors of building materials incorporated into a building used by the nonprofit. (The refund provisions do not apply to taxes on the purchase, lease, or rental of motor vehicles; state sales tax on electricity, piped gas, and intrastate telecommunications; local occupancy taxes for lodging and local taxes on prepared food and beverages; scrap tire and white goods disposal taxes; other states' sales and use taxes; and sales tax paid by employees or others and reimbursed by the nonprofit.) Regardless, the nonprofit must still collect and pay the sales tax on any products it sells. Refunds are claimed by furnishing information on forms provided by the Sales and Use Tax Division of the N.C. Department of Revenue by October 15 for taxes paid January-June and by April 15 for taxes paid July-December.

Local property tax. Nonprofits may qualify for local property tax exemptions, but you must file your application with the local county tax assessor and await determination. The decision of a local board may be appealed to the state Property Tax Commission. Contact your local county tax assessor or county tax office, or the N.C. Department of Revenue at www.dornc.com.

4.4 What are the disclosure obligations of tax-exempt organizations?

Informational filings. Most tax-exempt organizations must file annual tax information returns with the IRS. The annual tax information return (Form 990 for public charities) includes the nonprofit's balance sheet (assets and liabilities), income statement (revenues and expenses), list of officers, board of directors, key employees, and the compensation of the five highest-paid employees.

Some nonprofits need not file Form 990, including some churches, mission societies, state institutions, and public charities with gross receipts normally not more than $25,000 per year. (Tax-exempt private foundations file on Form 990-PF, and charities with gross receipts of less than $100,000 may file on Form 990-EZ through 2010.) The IRS tax determination letter will indicate whether one of these filing exemptions or categories applies. Beginning in 2008, tax-exempt organizations with gross receipts normally not more than $25,000 per year are required to file Form 990-N, an annual electronic notice known as the "e-postcard." Nonprofits that have unrelated business income must also file Form 990-T, even if they aren't otherwise required to file an annual report with the IRS.

In North Carolina, nonprofit corporations (other than hospitals) are not required to file annual reports. The only disclosure requirement arises in membership corporations where members have rights to inspect records of member or board action, as well as financial statements if the corporation has them. Charitable and religious corporations, however, can limit or deny inspection rights in the articles or bylaws.

Public disclosure. Nonprofits that qualify as 501(c)(3) organizations must make certain documents available to the public:

- Application for Recognition of Exemption, supporting documents and related correspondence (including the IRS determination letter)
- Copies of any federal information returns (such as Form 990) filed within the last three years (including amended returns), as well as all schedules, attachments and supporting documents.

These documents must be available for public inspection and copying during regular business hours at the organization's principal office and any regional office, and must be mailed within 30 days to anyone requesting a copy. The organization's returns are also available from the IRS for public inspection and copying, and many are now available online at www.guidestar.org.

There are penalties for not complying with these public inspection requirements. In addition, any person (including a nonprofit board member) who willfully and knowingly furnishes false or fraudulent information is subject to criminal penalties.

Disclosure of donors. Generally, the nonprofit need not disclose the names of its contributors. There is an exception for private foundations, which must disclose contributors of $5,000 or more.

Notice to donors. When a donor to a 501(c)(3) organization receives a "free gift" or other goods or services, the donor can only deduct the difference between the contribution amount and the fair market value of the gift, unless its value is insignificant. The IRS has said that the nonprofit is obligated to inform its donors that the full contribution amount is not deductible and indicate the fair market value of the gift.

Example

If the nonprofit has a website that solicits contributions, the website (just like any other written materials) will be subject to the tax and other rules on charitable solicitations. (See page 6 on "State licensing of charitable solicitations.") The board should be aware of how the nonprofit is raising money on the Internet and be sure that the nonprofit's management team has reviewed issues of legal compliance.

The nonprofit is also subject to state solicitation and contribution rules if it has arranged to raise funds through the websites of other organizations. The board should make sure the nonprofit's management team has reviewed these arrangements and regularly checks the websites. For example, if a nonprofit has links to other websites that constitute involvement in a political campaign, its tax-exempt status could be jeopardized.

ADDITIONAL SOURCES OF INFORMATION

Management Assistance Program for Nonprofits

- Organizational overview (for-profits and nonprofits)
  www.managementhelp.org/ org_thry/new_forms.htm
- Management library (including checklist for nonprofit boards)
  www.managementhelp.org/ www.managementhelp.org/org_eval/uw_brd.htm
- Basic responsibilities of nonprofit boards
  www.managementhelp.org/boards/brdrspon.htm
- Support Center for Nonprofit Management
  www.supportctr.org
- Lobbying and Advocacy Alliance for Justice
  www.afj.org
- Charity Lobbying in the Public Interest
  www.clpi.org

Nonprofit Corporate Law

- Mancuso, Anthony. How to Form a Nonprofit Corporation (8th ed. 2007)
  www.nolo.com
- N.C. Statutes and Nonprofit Corporation Act
  www.ncleg.net/gascripts/Statutes/Statutes.html (N.C. Nonprofit Corporation Act - search chapter 55A)
- N.C. Secretary of State
  www.secretary.state.nc.us/Corporations/

Nonprofits - General Information

- BoardSource (formerly National Center for Nonprofit Boards)
  www.boardsource.org
- Guidestar - National Database of Nonprofit Organizations
  www.guidestar.org/index.jsp
- National Center for Charitable Statistics
  www.nccs.urban.org/

Nonprofit Management

- Alliance for Nonprofit Management (FAQ)
  www.allianceonline.org
- American Bar Association Committee on Nonprofit Corporations. Guidebook for Directors of Nonprofit Corporations (2nd ed. 2002).
- BoardSource (formerly National Center for Nonprofit Boards)
  www.boardsource.org
- Internet Nonprofit Center
  www.nonprofits.org/

Tax Issues

- Internal Revenue Service
  www.irs.gov/charities/index.html
- N.C. Department of Revenue
  www.dornc.com

N.C. Center *for* Nonprofits

The mission of the N.C. Center *for* Nonprofits is to serve, promote, and represent the nonprofit sector and strengthen nonprofits' effectiveness as they improve North Carolina's quality of life. The Center serves as a statewide network for board, staff, and volunteers in 501(c)(3) nonprofits, an information center on effective organizational practices, and as an advocate for the nonprofit sector as a whole. It is a membership-based 501(c)(3) nonprofit corporation with more than 1,500 nonprofits working together in all 100 counties of North Carolina.

The Center has a number of resources to serve the public including:

- Board and Staff Helpline: A place for nonprofits to contact with questions on any aspect of nonprofit management and leadership.
  919/790-1555, ext. 220 or www.ncnonprofits.org/askthecenter.asp
- Information on the Center's website, including Frequently Asked Questions, *Principles & Practices for Nonprofit Excellence: A Self-Help Tool for Organizational Effectiveness*, and links to other state and national partners providing information and assistance to nonprofits.
  www.ncnonprofits.org

Business Law Section
North Carolina Bar Association

The North Carolina Bar Association is a voluntary organization whose mission is to serve the public and the legal profession by promoting the administration of justice and encouraging the highest standards of integrity, competence, civility and well-being of all members of the profession. Founded in 1899, the Bar Association serves both attorneys and the general public with programs that include legal information materials, the Lawyer Referral Service, and support for pro bono legal services.

The Business Law Section, with over 1500 members, brings together lawyers and other legal professionals of the Bar Association who have a special interest in the practice of business law.

The Bar Association offers a number of services to the public including:

- Lawyer Referral Service: For members of the public who need an attorney or think they may need one, this service is available at a charge of no more than $30 for up to 30 minutes for the initial consultation.
  1-800-662-7660; Raleigh/Durham/Chapel Hill: (919) 677-8574

- NC Center For Non Profits Pro Bono Program: Members from various sections of the Bar Association, including the Business Law Section, volunteer to provide one-hour legal assistance to smaller nonprofits in North Carolina.
  919/790-1555, ext. 220