

GOVERNANCE FOR NONPROFITS

Good

Nonprofit Governance

*creates a corporate atmosphere that
generates confidence within the organization
in each individual's ability
to successfully complete their mission
and results in a cohesive institution
that builds confidence
in volunteers understanding
the value of their contribution
of time and talent
and in donors believing
their contribution of treasure
is appropriate and worthwhile.*

GOVERNANCE FOR NONPROFITS

*A Board of Directors Guide
to a Profitable Not-for-Profit
Corporation*

TED E DEGROOT



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Governance for Nonprofits
A Board of Directors Guide to a Profitable Not-for-Profit Corporation

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Preface

This is not a true “How To” book. It is more a combination of material, more an instruction manual or textbook; a large collection of information related to the operation of a not-for-profit business organization.

GOVERNANCE for Nonprofits explains the terms and required elements for the operation of a nonprofit business, shows examples of how others have approached specific areas of operation, and provides guidelines for the various common functions of a nonprofit. And in a few cases uses simple terms to help the reader identify nuances in practice. In limited instances, the book lists options as suggestions to present concepts that would require more space than is worthwhile.

As such, GOVERNANCE is more of a reference book than a treatise.

Explanation:

A treatise is defined as: “A systematic exposition or argument in writing including a methodical discussion of the facts and principals involved and conclusions reached.”

www.merriam-webster.com/dictionary/treatise

As mentioned above, the book uses occasional boxed interruptions in the flow of the information to offer material that might help clarify a point, explain an uncommon term, or in some cases, offers trivia related to the topic, but always with the objective of explaining the subject at hand.

Like the quotation above, most of the information in this book was garnered from the internet rather than from other books. To simplify and identify the source of the information, the relevant Universal

Resource Locator (URL) is quoted directly below the text rather than numbered and set in a separate section devoted to footnotes. In a limited number of cases, where the source is widely available, it may just be noted.

When a material is directly quoted, that material is identified and credited. So, unless it is obvious what the source of the material is, the material is identified and indicated by enclosure in a shaded box with an explanation, usually an internet address:

When in the Course of human events it becomes necessary for one people to dissolve the political bands which have connected them to another ...

www.ushistory.org/Declaration/document/
The United States of America, Declaration of Independence

Sometimes the material is taken from other sources and modified to suit the book’s purpose. In that case, the material is indicated by enclosure in an unshaded box, and the source is usually credited:

When it becomes necessary for people to dissolve the political parties that have connected them to each other ...

www.ushistory.org/Declaration/document/
The United States of America, Declaration of Independence

Throughout this book, to clearly define the subject of a definition, the defined ‘term’ may be enclosed in apostrophes as a literary device to assure there is no confusion about what is being described.

Lastly, this book should not be used as a sole source of information. **Before implementation, all steps of corporate formation and many other**

potential operational changes should be reviewed by an attorney familiar with nonprofit law.

Introduction

AN OBSERVATION

Over the past few decades, I have observed the Board of Directors for some non-profit organizations are highly effective, and some are grossly ineffective. It is not a matter of the quality of the board members or even the quality of the leadership provided by its officers. Almost all directors are intelligent, dedicated individuals.

What separates functional from dysfunctional organizations is not so much different opinions about the organizational direction or that individuals strongly support a 'personal agenda' as trying to function within a weak structure that does not provide a defined mission and a sufficiently defined bylaws and policies.

This book codifies and explains what works (and occasionally what does not work) for not-for-profit organizations and explains why a path of little resistance is a path to controversy and a lack of good governance almost always results in the inability of a board to function smoothly.

For the record, there is a significant difference between the commitment people make to serve on a for-profit and not-for-profit board. For-profit board members usually make a long-term commitment to serve on the board with no specified term limit. Not-for-profit boards seem to be best served by having directors' terms limited. That alone creates a different atmosphere within the board and changes how an organization operates.

Rationale for the Book

Some boards are highly effective and some that wallow in confusion, overloaded with good ideas while ostensibly within the

power of the directors to fulfill, are truthfully out of reach for the structure and personnel of that board; mostly because the board is unorganized, and members do not understand their individual responsibilities within the organization.

This book deals primarily with organizational elements: How to put together a Board of Directors that works, something called Governance.

Definitions

Definitions as used in this book:

Ad Hoc in Latin means "to or for this."

Today, ad hoc is often used to describe an activity formed for and limited to a specific purpose; most often, a temporary committee is formed to explore or accomplish a closely defined responsibility.

Board refers specifically to a Board of Directors or a Board of Trustees or a Board of Governors as a group of individuals dedicated to a specific mission within a specific organization. **Board** refers to a generic Board of Directors, Trustees or Governors.

Bylaws or **by-laws** have the same meaning and refer specifically to a document that elucidates the rules under which a corporation must operate. Written without a "-" is now the accepted way to write the word, 'Bylaws'.

Confidentiality Agreement is a contract between an organization and an individual to assure certain information is only communicated, either verbally or in written form, with authorized individuals and done so in a manner that assures privacy.

Council is a board of councilors, an advisory council.

Councilor is a member of an advisory council.

Director is a member of a board of directors.

Director Emeritus is a person who was a director, is not at the present time, but continues to advise the board or the organization.

Evaluation Firm is a source of information about an organization. GuideStar, Social Solutions, and the National Council of Nonprofits are examples of organizations dedicated to gathering information about nonprofits regarding their stated purpose, fulfillment of that purpose, organization (usually determined by review of their Articles of Incorporation and Bylaws), published financial statements, IRS forms and other data, then makes that data (and sometimes, their evaluation of the organization) available to interested parties, mostly to potential donors.

Ex officio is a designation of an individual who holds office, such as a board member, due to the person's position or status. i.e., The president of one group is an automatic member of another group. For example, the chairperson is an automatic member of all committees. Ex officio members can have a voting or non-voting status within the group.

Fiduciary is an individual or group's ethical and financial obligation to act in the best interest of another. Most often coupled with the word "responsibility."

For-profit versus **for profit**. In this book, there is a frequent explanation of differences between an organization founded to make a profit for shareholders and an organization with no shareholders and not intending to make a profit. To separate simply working 'for-a-profit' from working 'not-for-profit', firms operating

to make a profit are usually termed 'for-profit'.

Functional in reference to a Board of Directors:

Functional is operating normally or more specifically, optimally.

Dysfunctional is operating but not performing optimally due to internal strife.

Malfunctional is operating, but performing below optimal levels due to its practice of weak governance or lack of governance altogether.

Nonfunctional is not capable of operating, most often because it does not operate at all.

Governance is the act of managing a people or actions. Referenced to a Board of Directors, it includes managing legal requirements, good personnel policies and practices, guidelines for operations and oversight of how the board communicates, particularly with each other. Most simply stated, governance is the development, modification, and enforcement of the letter and spirit of bylaws.

Governor is a member of a board of governors.

Governors refers specifically to a group of individuals charged with overseeing or 'governing' the operation of an organization. Essentially a board of directors, but with somewhat different responsibilities.

Indemnity or **Indemnify** relates to protecting someone or something, usually against loss or financial burden.

Members usually refers to 'general members', those individuals not seated on a board or council but having expressed, usually by paying dues, interest and commitment to an organization. Individuals sitting on a board or committee are usually identified by a specific title, most often 'directors'.

Minutes is a written record of the proceedings of a meeting. Except for motions and amendments that are recorded verbatim, minutes are usually not

recorded verbatim but condensed to indicate the main points of discussion.

Nonprofit versus **Not-for-Profit**. There is no practical difference between the two words. That said, ‘not-for-profit’ is a very clear statement indicating intent, as in a business that could either operate as a for-profit or not-for-profit; a hospital being a prime example of a business where some organizations operate for-profit, some as not-for-profit. ‘Nonprofit’ could be a statement of fact (The business operates without a profit.) versus intent (The business operates without intent to make a profit and purposefully distributes all income.). Today, ‘nonprofit’ is the preferred way to refer to any business not operating as a ‘for-profit’ entity.

Policy is a documented position statement, subject to change, stating an official position regarding a defined subject or an approved plan outlining a course of action relative to ongoing or anticipated operations.

Pro bono or **pro bono public** is ‘for the public good’. The term describes work done by a professional without charge. For nonprofits, ‘pro bono’ usually relates to work done by an attorney or accountant working without compensation.

Staff refers to paid or volunteer individuals who function regularly to accomplish the organization’s goals.

Stakeholder describes a person or entity with a significant interest in an organization, its operations and its success.

Trust an entity established to benefit a defined person, group of persons or an organization.

Trustee or **Trustee-s** a board of trustees’ member.

Trustees refers specifically to a Board of Trustees that is likely to have more fiduciary group and individual responsibility for the operations of the organization than a standard board of directors.

Identifying Nonprofits

There are several types of nonprofits. The most common is a 501(c) (3), a tax-exempt charity. But there are others too (See *Chapter 1, 501 Classes (a)–(h)*). To simplify matters, this book might use the term ‘501s’ to talk about all classes of nonprofits or ‘c8s’ to address a specific class rather than stating ‘**U.S. Code; Title 26; Subtitle A; Chapter 1; Subchapter F; Part I; § 501(c)(8)**’.

After all, the book deals only with 501s.

SECTION I

Legal and Semi-Permanent Organizational Structure

Structure is necessary for a business, in fact, any organization, to function.

Since the advent of writing and reading, man has written down rules for society and how we relate. The Ten Commandments, and before them, the concept of marriage are manifestations of structure. We live reasonably orderly lives due to laws and

set expectations for how things are done. That is structure.

When agreed by those empowered to determine what is worthy of being a formally recognized custom or procedure, and then recording and publishing that standard for all to see, it becomes what we call the definition of expected actions or 'laws'.

Chapter 1

Laws

LAYERS OF LAWS

All Boards of Directors are governed by laws; actually, multiple layers of laws. The higher the layer of governing law, the greater the responsibility of the board and individual directors within the board to abide by those laws.

NATIONAL LAWS

The highest enforceable laws are the laws of the land. Specifically, those laws imposed by the national government and, to a lesser degree, those by international agreement. For an organization, these are laws providing general definitions of what constitutes a business, what structure a business is allowed, and laws that govern certain operations and practices of businesses.

Tax laws are the second level of regulation, setting borders on what actions constitute a business class, describing attributes common to operations for similar businesses and limiting what the business can do legally.

At this level, businesses are currently defined as an entity that has a single owner (a sole proprietorship) or a limited number of owners (commonly a partnership) or multiple owners (a corporation), or no owners (a nonprofit corporation).

Variables

Corporations and partnerships both have some variations in how they can be structured.

Comment:

What follows are highly simplified explanations of business types and should not be regarded as a complete definition. Consult a corporate attorney for more complete definitions.

Corporations

Corporations offer certain protections to owners from litigation for actions of the corporation and have four classifications:

Corporations having an 'unlimited number of owners,' most of whom are not involved in the operation of the business, are a "C" class corporation. Profit from the actions of the business is taxed, and the remaining amount not held in reserve is distributed to stockholders as dividends. Dividends are subject to taxation as a part of an individual's income and may be taxed at a rate separate from simple income.

Smaller companies with 'limited number of owners,' who are directly or indirectly involved with the business, can elect to be an "S" Corporation. Income from an "S" Corporation is distributed directly to the owners and treated as simple earned income.

Personal Corporations, a "PC" is 'usually a single person, but can be more,' that provides personal services to the public, and all PC owners participate in the process of providing the service. Owners can choose to be taxed as either a "C" or "S" corporation.

Nonprofit corporations have 'no designated owners.' They are managed by a

group of responsible individuals designated as a board of directors (or something similar) and use all their income to further the corporation's goals. Nonprofits do not pay a national tax on income, and there can be no distribution of excess earnings to any entity or individual.

Partnerships

Partnerships offer limited protection for individual owners but are less regulated, easier to form, and still offer certain tax advantages.

Partnerships have three common variables:

There are general partnerships with a fairly 'limited number of partners,' most individuals equally responsible for the actions of the business and sharing profits equally from its operations and paying tax on those earnings as simple income.

In unlimited general partnerships, there may be 'multiple partners' who share the business's profits and liabilities equally.

In limited partnerships, all partners invest equally in the business and share the profits. Some individuals may however not participate in the management of the business or in the liabilities of the business.

Limited Liabilities

Limited Liability Companies (LLC) and Limited Liability Partnerships (LLP) are state-authorized entities that enjoy some protections and tax advantages offered to shareholders in a corporation but still can operate as a sole proprietorship in the case of an LLC or partnership in an LLP.

Personal Corporations

A Personal Corporation (PC) is a state-authorized service organization, usually a 'single individual' who works on behalf of

an employer as an independent contractor. While most PCs operate as a single individual, there may be multiple individuals within the PC, most often supporting the principal's efforts.

Personal Service Corporations

Some states offer Personal Service Corporations (PSC), a combination of a Personal Corporation and a regular Corporation are subject to specific industries and tax regulations.

Explanation:

At this point, only corporations are eligible for nonprofit status under the tax codes of the United States.

Nonprofit Eligibility

Unlike a for-profit business where income after expenses or 'profit' is distributed to shareholders, in a nonprofit corporation, there is no expected surplus income eligible to be taxed by the federal government. A for-profit business can only operate for a limited time without producing a profit before the Internal Revenue Service declares the business illegal and imposes fines and penalties on the business.

Explanation:

A nonprofit may operate a for-profit business with the expectation that all profits generated after paying taxes accrue to the nonprofit.

Only by applying to the Internal Revenue Service and being granted a Section 501 status (see below) can a corporation be certified as a nonprofit. Until that certification is granted, the corporation is treated as a for-profit organization even if there are no shareholders.

Comment:

Good places to start an application for nonprofit status are:

- www.irs.gov/charities-non-profits/applying-for-tax-exempt-status
- www.ein-assistance.com/form?entity-type=non-profit-organization

Currently, there are request-for-certification packets available online at www.irs.gov.

Most Section 501(c)(3) (see below) charitable organizations with gross receipts of \$50,000 or less and assets of \$250,000 or less are eligible for a short-form application. Organizations that do not meet these qualifications and other classes (listed below) of nonprofits must complete a long-form application and expect a longer period before certification.

Both forms require the organization to be in place and have an IRS employer identification number (EIN) to apply for

nonprofit status. Applicants can ask for the effective date of the nonprofit status to be earlier than the date of the application. Still, it is recommended that an application to be identified as a nonprofit be filed as early as possible to avoid deadlines and significant paperwork to justify an earlier date.

All the steps of corporate formation should be reviewed by an attorney familiar with nonprofit law prior to implementation.

501 Classes (a)–(h)

There are over thirty classifications for nonprofit corporations, most filed under U.S. Code; Title 26, with the glyph ‘§ 501’ exemption from tax on corporations, certain trusts, etc.

Below is a compressed selection of the code – starting at Section 501(a) – and is intended only to provide general information regarding the actual code.

U.S. Code; Title 26; Subtitle A; Chapter 1; Subchapter F; Part I; § 501

- a. An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied elsewhere in the code.
- b. An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in parts II, III, and VI of Subchapter F, but (notwithstanding parts II, III, and VI of this subchapter) shall be considered an organization exempt from income taxes for any law which refers to organizations exempt from income taxes.
- c. The following organizations are referred to in subsection (a):
 1. Corporations organized under the Act of Congress, which is an instrumentality of the United States that is exempt from Federal income taxes.
 2. Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization that is exempt under this section.
 3. Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of

- inures to the benefit of any private shareholder or individual.
4. Civic leagues or organizations not organized but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.
 5. Labor, agricultural, or horticultural organizations.
 6. Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players) not organized, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.
 7. Clubs organized for pleasure, recreation, and other non-profitable purposes.
 8. Fraternal beneficiary societies, orders, or associations.
 9. Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries.
 10. Domestic fraternal societies, orders, or associations, operating under the lodge system.
 11. Teachers' retirement fund associations.
 12. Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations.
 13. Cemetery companies owned and operated exclusively for their members' benefits; and any corporation chartered solely for the purpose of the disposal of bodies by burial or cremation that is not permitted by its charter to engage in any business not necessarily incident to that purpose.
 14. Credit unions without capital stock organized and operated for mutual purposes and without profit.
 15. Insurance companies other than life.
 16. Corporations organized to finance the ordinary crop operations of members.
 17. A trust or trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits.
 18. A trust or trusts created before June 25, 1959, forming part of a plan providing for the payment of benefits under a pension plan funded only by contributions of employees.
 19. A post or organization of past or present members of the Armed Forces of the United States, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization.
 20. A trust or trusts established in writing, created or organized in the United States, and contributed to by an individual.
 21. A trust or trusts established in writing to insure Black Lung disease liabilities in persons.
 22. A trust created or organized in the United States and established in writing by the plan sponsors of multi-employer organizations.
 23. Any association organized before 1880, more than 75 percent of the members of which are present or past members of the Armed Forces, and a principal purpose of which is to provide insurance and other benefits to veterans or their dependents.

24. A trust described in section 4049 of the Employee Retirement Income Security Act of 1974.
25. Corporations or trusts which has no more than 35 shareholders or beneficiaries organized for the exclusive purposes of acquiring real property and holding title to, collecting income from, such property, and remitting the entire amount of income from such property to shareholders.
26. Any membership organization established by a State exclusively to provide coverage for medical care.
27. Any membership organization to reimburse its members for losses arising under workmen's compensation acts.
28. The National Railroad Retirement Investment Trust established under the Railroad Retirement Act of 1974.
29. Co-op Health Insurance issuers that have received a loan or grant under a CO-OP program.
- d. Deals with religious and apostolic organizations that distribute their gross income to their members.
- e. Deals with cooperative hospital organizations.
- f. Deals with cooperative service organizations, a part of an operating educational organization that makes investments and distributes the income less expenses to its members.
- g. A delimitation of "Agricultural."
- h. Denies nonprofit status to political lobbying groups under certain circumstances, even if the members individually qualify as nonprofits.

Comment:

www.law.cornell.edu/uscode/text/26/501 provides a more complete synopsis of the code.

Despite the diversity in the types of nonprofit organizations, most share four things in common:

- An interest in helping others do what individuals cannot do for themselves alone.
- A desire to work for the betterment of others or their members.
- Usually, nonprofits start small, hoping to become larger and more effective.
- The organization needs to raise money from outside sources to finance its endeavors.

Explanation:

The most common exceptions to the need to raise funds for a nonprofit are certain types of trusts established as a nonprofit and trade organizations or fraternal organizations that charge their members a fee to cover the costs of benefits.

Industry-Specific Laws

There are national laws that apply only to specific industries, whether the operating entity is profit-oriented or non-profit qualified. For example, laws regarding employee/management relations are universal in application. Likewise, commerce of all types is impacted by national laws. Product quality and safety issues, regulation of air space, and electronic communication are other examples. National laws are often intended to ensure safety for the general public and/or to avoid confusion. Driving on the right side of the road, red for stop, the Interstate highway system, weight and length restrictions for vehicles are nationally regulated but may be modified by localized regulations.

Comment:

Vehicle usage in mountainous areas is a good example of localized control. States, or even counties, can impose restrictions on the length of a vehicle eligible to use the road, the use of snow chains, and can open and close roadways due to local conditions.