Getting Started: Factoring State Nonprofit Law into Corporate Development

Nonprofit corporations are creatures of state law for corporate status and operations, while also subject to federal law for tax-exempt purposes. Under which state law should a nonprofit incorporate, and what other state corporate requirements should be considered? The following questions and answers provide guidance in both areas for nonprofit leaders seeking successful development, compliance with related IRS tax-exemption aspects, and long-term organizational vitality.

Q: Is it always best to incorporate under a state nonprofit law?

A: Generally yes. Other options include (a) operating as an unincorporated association; (b) forming a charitable trust; or (c) forming a limited liability company. Given an unincorporated association's potential risk for personal liability to its leaders, a corporate entity is nearly always the preferred choice. Under limited circumstances, a charitable trust can be a useful alternative provided the trust doesn't anticipate operating programs or having employees.

Many states' laws enable a LLC to be formed and operated for nonprofit purposes too, which can also be useful under the right circumstances. One simple example is when a nonprofit forms a LLC to hold real property or conduct a specific program. The nonprofit corporation in this example operates as the sole member to the LLC, not private individuals.

Q: How is an organization incorporated?

A: A nonprofit corporation is "born" (i.e., formed) as a legal "person" through the filing of written articles of incorporation with a state's Secretary of State office (or similar agency). The articles function essentially as the new corporation's "birth certificate." Typically, the articles contain the organization's name, list of initial directors, a well-crafted purpose statement that serves as the organization's foundational cornerstone, a registered agent to receive official notices, a list of corporate limitations consistent with tax-exempt qualifications, and a dissolution clause.

Q: Is there a best state for nonprofit incorporation?

A: Generally no. The commonly understood advantages that Delaware and Nevada offer for for-profit business incorporations do not apply to nonprofits. A majority of the states have adopted some version of the Model Nonprofit Corporation Act, with resulting similarity among the state nonprofit laws. There are, however, a handful of important exceptions, and some states where it may be better to avoid incorporating if possible. For example, New York's laws governing nonprofits can be particularly burdensome and thus it may be easier to incorporate in a different state and register to do business in New York.

Q: What organizational factors should be considered in deciding on a state of incorporation?

A: Given that state nonprofit laws are similar overall, the appropriate factors to consider are often primarily geographical. More specifically, will the organization have a physical office and/or a facility for carrying out programs? Where are its key leaders? If the new nonprofit's leadership and programs are expected to be in a certain state, then it most likely should be incorporated there. If the new nonprofit will be national in scope or not necessarily limited to one location, then its leaders should evaluate what state will likely be best long-term for the organization.

Keep in mind that once an organization is incorporated under a state's nonprofit law, such corporate formation status will typically remain for its entire existence (just as a person's state of birth could never change). Accordingly, should an organization move its primary activities to another state, or expand physically to additional states, it will likely need to remain registered in the state of its origin plus register to do business in such other states. A few state nonprofit laws allow for "domestication," that is for a corporation to move in or move out of a state as its state of incorporation, but such flexibility is rare.

Note too that a few states do not easily provide for "D/B/A," or "doing business as" registrations, which are also known as assumed name registrations. So this consideration may be a factor for an organization planning to operate under another or additional corporate nickname.

Q: What are some key differences among state nonprofit laws?

A: A specific state's nonprofit act should always be carefully reviewed in connection with developing a nonprofit organization's bylaws and other governance mechanisms. Remember the state law where an entity incorporates governs the nonprofit, even when the nonprofit's principal place of business is in another state.

The following areas of comparison focus on Illinois and South Carolina, based on our law firm's offices, but with due consideration for other state law differences as well.

1. Corporate Purpose.

A nonprofit's corporate purpose statement is required to be set forth in the new organization's articles of incorporation. The Illinois law contains a list of 34 authorized purposes. The South Carolina law requires only a statement that the corporation is a public benefit, mutual benefit, or religious corporation.

As a best practice, the purpose statement under most states' nonprofit laws should be a highly distilled and well-developed descriptive statement, usually about 50 words or less. As the written cornerstone of the new corporation, the purpose statement helps focus leaders, donors, and others regarding the organization's activities and tax-exempt nature. Nonprofit leaders owe a fiduciary duty of obedience to such purpose statement, keeping the organization's activities and future development consistent and informing their vision.

Some state statutes require additional specificity to be included in the corporate purpose and even an outside government agency to approve the purpose prior to filing the articles. It is therefore important to carefully study the statutory purpose statement prior to filing.

2. Corporate Name.

Rules governing corporate names can be significantly different. States vary in whether certain words or suffixes like "corporation," "company," "incorporated," or "limited," or an abbreviation of one of the words is required. In Illinois, if the corporate name contains any word or phrase indicating or implying that the corporation is organized for any purpose *other than* the organization's nonprofit purpose, the corporate name must include the ending appellation "NFP." On the other hand, South Carolina law does not prescribe any naming conventions. However, the corporate name may not contain language stating or implying that the corporation is organized for other purposes that are not nonprofit or inconsistent with its corporate purpose.

Many states also allow a prospective corporate name to be reserved by making the appropriate filing with their respective offices of the Secretary of State. The corporate name must be distinctive and not too similar to already incorporated organizations, whether nonprofit or for-profit. Finally, there are often certain words that cannot be included in a

corporate name unless approved by a different state agency. For example, the term "college" cannot be used in Illinois unless the entity has operating authority from the Illinois Board of Higher Education.

3. Directors.

Most states require that a nonprofit corporation list at least three directors on its articles of incorporation, although a few states require only one or even simply an incorporator (South Carolina). As a best practice, it is generally best to have at least three directors, and the IRS will expect such minimum number as a reflection of good governance (and therefore legal compliance with other aspects of tax-exempt qualification). A group of disinterested, independent leaders should promote collective decision-making for the nonprofit's best interests, in keeping with each leader's fiduciary duty of loyalty to the organization, and to promote public benefit, consistent with Section 501(c)(3) qualification. Note too that state laws generally allow for as many directors as the organization may wish, although Illinois law requires that bylaws provide a prescribed range of five (e.g., 3 to 8, 4 to 9, or 5 to 10).

4. Member Rights.

Membership is a typical component for many nonprofits including religious organizations, trade associations, and social clubs. Nonprofits may wish to provide specific governance rights to members through the bylaws, such as the ability to elect directors and officers or to vote on other major decisions. Note, however, that some organizations may use "membership" as a purely honorific designation, connoting inclusion but not necessarily governance or other rights.

State statutes should be carefully reviewed for applicable membership rights, which can vary from state to state. Under Illinois law, members automatically enjoy rights of access to the nonprofit's board minutes, financial records, and other organization documents, but only on a generalized basis. South Carolina allows members to inspect articles of incorporation, bylaws, meeting minutes, board resolutions relating to membership, written communications to members, and reports required to be filed with the Secretary of State, all upon five days' notice. Members must ordinarily make a good faith demand for a proper purpose, described with reasonable particularity.

With respect to membership termination, many states including Illinois allow a member to be expelled or suspended for any or even no reason – without any "due process" rights unless specifically mandated in the nonprofit's bylaws or other governing policies. In stark contrast, South Carolina law prescribes that a member may not be terminated or suspended except pursuant to a procedure that is "fair and reasonable" and carried out in good faith. Appropriate procedures include prior written notice, stated reasons for such adverse action, and an opportunity to be heard.

5. Notice.

Notice for directors' meetings, members' voting rights, and other important operational aspects should be given in compliance with both the nonprofit's bylaws and nonprofit state law. Notice may generally be given via email, mail, or personally. Typically, the state nonprofit law will contain outer limits for notice, such as Illinois' requirement of at least 5 days and not more than 60 days' notice for directors' meetings - with certain significant actions such as dissolution or a merger being increased to at least 20 days. Most states' statutes allow for notice requirements to be waived by the directors' presence at board meetings (except to object to notice). Such notice requirements may sometimes be satisfied by a predetermined standing schedule (e.g., board meeting every first Tuesday of the month). Note too that legal notice requirements for membership meetings may be different than for board meetings, and special notice requirements may apply for extraordinary actions such as merger, removal of a director, or corporate dissolution.

A distinctive in South Carolina, Missouri, and other states is that notice generally may be verbal as long as it is "reasonable" under the circumstances, and it is effective when communicated if communicated in a "comprehensible manner." Given inherent uncertainties and potential confusion with verbal notice, however, such approach would not be a "best practice" for most nonprofit organizations.

6. Meeting Participation.

Most state nonprofit laws expressly provide for meetings that include attendance by some or all participants via teleconference or videoconference. In Illinois, such participation is permissible so long as (1) it is not specifically prohibited by the articles or bylaws; and (2) the conference equipment allows for all attendees to "communicate with each other." South Carolina law similarly provides that a nonprofit board may permit any or all directors to participate in a board meeting via "any means of communication by which all directors participating may hear each other simultaneously during the meeting." Note further that in some states, a participant's stated objection may preclude such technology-assisted meeting format, if it is made sufficiently in advance. Neither the Illinois nor South Carolina nonprofit acts contain such provisions, although corporate bylaws certainly could allow for such objections.

7. Limited Liability and Indemnification.

Bylaws should provide for directors' and officers' limited liability and indemnification in accordance with applicable law, and preferably accompanied by directors' and officers' insurance that includes coverage for legal defense costs. Illinois law provides that a nonprofit corporation may indemnify any person by reason of the fact of being a director, officer, employee, or agent or who is or was serving at the request of the corporation against expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement

actually and reasonably incurred, if such person acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, the best interests of the corporation. South Carolina law is almost identical to Illinois.

Keep in mind that generally speaking, anyone can file a lawsuit. Volunteer directors may not be held personally liable to others in connection with their service to nonprofits unless they engage in egregious activity, such as “gross negligence” or intentional misconduct. By contrast, paid directors may face personal liability for their nonprofit service based on the lower legal standard of “ordinary negligence.” Whether paid or volunteer, however, all directors may otherwise face personal liability under other state or federal laws. For example, a director personally involved with illegally diverting employment taxes may be liable under applicable tax laws. In addition, a director who either receives an improper private benefit or approves of such payment may be personally liable under the IRS’s “intermediate sanction” prohibitions for excess benefit transactions. A director may also face personal liability if he or she breaches applicable fiduciary obligations of due care and loyalty owed to the organization.[1]

Concluding Remarks

Where should your nonprofit organization incorporate? Probably in the state where the key leaders reside and from which they operate. How should the nonprofit proceed with incorporation? The nonprofit leaders should be well informed with respect to applicable state laws, particularly for bylaw development, as well as federal tax compliance and best practices considerations. Then go forth and promote the new nonprofit organization’s worthy purposes!

[1] A related area is whether and the extent to which a charitable organization may be liable for torts committed by its agents (apart from such agents’ potential personal liability). A majority of states including Illinois do not recognize charitable immunity, but some states including South Carolina limit their liability in some form. More specifically South Carolina caps liability for "charitable organizations", which are defined as any organization, institution, association, society, or corporation which is exempt from taxation pursuant to Section 501(c)(3) or 501(d) of the Internal Revenue Code. Charitable organizations may be held liable for the acts or omissions of their employees, which includes agents, servants, employees or officers, when the employee is acting within the scope of his employment.

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