Life Cycle of a Nonprofit Corporation

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“From our birthday, until we die, / Is but the winking of an eye." - William Butler Yeats

How exciting to start a nonprofit, to dream about all the good to accomplish in the world! The starting passion, joy, and energy drives nonprofit founders to put in the time, effort, sacrifices, and money to create a new organization that will grow, change, and mature, in many ways like a human life will develop or a seed will take root and grow.

What are the legal aspects of a nonprofit corporation’s life cycle? It starts with “birth” or formation, then the first steps of corporate development, and onward into operational governance. Later nonprofit life comes with potential transitions like mergers and multi-entity structuring (i.e., corporate “marriage” and “children” or subsidiaries), and then possibly dissolution (i.e., “death,” at least in the legal sense). Many legal compliance and best practices considerations come into play for each stage.

Part 1: Birth

While significantly less fanfare (no bloodshed, thankfully!) accompanies the birth of a nonprofit corporation than that of a human being, similarities abound for this legal “person.” The government is involved right from the start. A nonprofit corporation is “born” when its organizers file articles of incorporation (or a similar charter document) with the relevant state agency in its home state (usually the Secretary of State). Like a birth certificate, articles of incorporation include the organization's name and date of birth (formation). Unlike a birth certificate, articles of incorporation provide corporate protections to the organization's leaders and serve as an organizational cornerstone for the rest of the nonprofit's life.

Initial Documentation

The articles of incorporation contain the corporation's purpose, the names of the organization's initial directors, the name and address of the organization's registered agent, and dissolution language addressing disposition of assets upon the end of the corporation's life. If the organization intends to be a "charitable organization," the corporate purpose statement will include one of the several potential exempt categories under Internal Revenue Code Section 501(c)(3), the most common being charitable, religious, educational, or scientific. Most importantly, the corporate purpose statement will serve as a legal manifestation of the founders' intent for the organization, and it should therefore be carefully considered to guide the entity's leaders, to inform donors, and to educate governmental agencies.[1] (Note too that the articles may later be updated in a variety of ways through articles of amendment.)

After it is officially "born," a nonprofit should adopt bylaws. The bylaws effectively function as the entity's corporate structure (like a human skeleton), setting the parameters by which the organization moves through corporate governance and action. Each nonprofit's specifically tailored bylaws shape the organizational structure and election of its board of directors, meeting requirements, manner of acting, and policies for difficult issues such as conflicts between directors. Note that each state's nonprofit laws may prescribe default or superseding requirements for what an organization's bylaws must include such as number of directors, meeting notices, and officer information. Additionally, every nonprofit organization should follow many "best practices" in connection with its unique governance structure, operations, and mission. Significantly, human beings cannot modify their skeletal structure (absent surgery or a significant injury), but a corporation's board may elect to modify or improve bylaws over time through amendments.[2]

First Steps – First Minutes

Just as a child will take first steps, a corporation takes its first official governing steps in through its first meeting of the Board of Directors. Directors may meet in-person, or via teleconference, or videoconference. In cases where the directors' collective perspective on the proposed initial corporate actions is quite clear, the Board may act without a meeting through the unanimous written (including email) consent of all the directors. The matters for consideration at the organization's first meeting should include: (a) approval of the filed articles of incorporation; (b) approval of the bylaws; (c) composition of the Board; (d) the directors' initial terms; (e) the appointment of officers; (f) ratification for retention of legal counsel; (g) identification of the organization's bank and designation of certain officers as bank signatories; (h) authorization for developing and filing the IRS Form 1023 taxexemption application, if the organization is a public charity;[3] and (i) recognition of each director's completed and signed annual disclosure statement, addressing any conflicts of interest.[4]

Parents often videotape a child's first steps. Actions taken by the board in this first meeting should be similarly memorialized through the nonprofit's initial corporate resolution – typically known as "First Minutes."[5] Just as a parent lovingly encourages those first steps, remember that the time and thought put into preparing and executing the nonprofit's first minutes are well worth the effort!

Part 2: Flourishing Life

Once a nonprofit is up and running, its founders shift their focus to the organization's ongoing operations. The board of directors oversee the overall vision and mission of the nonprofit organization, while the key workers (whether paid staff, volunteers, or a combination) manage the nonprofit's day-to-day activities and implement the board's vision.

A nonprofit corporation will best thrive and fulfill its mission if led by responsible leaders who understand their duties to the corporation and seek to govern according to best practices. Leaders of nonprofits encourage compliant and ethical governance by means of scrupulous commitment to their fiduciary duties and careful development of, and adherence to, best-practice policies. Following these guidelines is vital to keeping nonprofits alive and well, enabling them to continue pursuing the objectives they are capable of achieving. Think about a strong, vibrant young adult, courageous and ready to tackle all sorts of challenges!

Fiduciary Duties

Directors and officers of nonprofit corporations have three fiduciary duties to the organizations they lead: the duty of care (or diligence), the duty of loyalty, and the duty of obedience. Failure to adequately act in keeping with these duties may result in personal liability for directors and officers as well as negative consequences for the nonprofits they administer. The fiduciary duties may be summarized as follows.

- The duty of care requires directors and officers to keep informed about the organization's activities and finances, avoid misuse and waste of the organization's assets, and engage experts and professional advisors when necessary to reach informed decisions.[6]
- The duty of loyalty requires directors and officers to guard against any misappropriation of the nonprofit's assets, to refrain from using their positions of trust for personal gain, or to confer special benefits on friends and family, and to disclose any conflicting interests that arise.[7]

- The duty of obedience requires directors and officers to adhere to the organization's purpose as stated in the organization's charter documents and to comply with legal requirements for tax-exempt entities.[8]

Best Practice Policies

Armed with the knowledge of their legal and ethical duties to the organization, directors and officers should develop, implement, and carefully follow best-practice corporate policies. The entity's policies function both as a guide to keep decisionmakers from running afoul of legal requirements and as a defense against potential allegations of impropriety. In addition to following these policies, nonprofit leaders should ensure responsible governance through holding regular directors' meetings, keeping careful minutes at those meetings, and faithfully preparing annual reports.

One extremely important policy is the entity's conflict-of-interest policy, which addresses situations that arise when a director or officer has a personal interest that conflicts with that of the organization. Conflict-of-interest policies contain specific procedures ensuring that the organization's governing body is informed of any conflicts of interests and that no conflicted transactions are entered into unfairly, improperly, or unawares.

A strong dispute resolution policy similarly protects the organization by pushing a nonprofit's stakeholders to legal remedies apart from litigation, where possible. Other examples of best practice policies include employment policies, grantmaking policies, investment policies, and written information security policies.

Corporate Transitions

Like people, nonprofits go through various stages of transition and growth over the course of their lives. As a person may get married or have children, a nonprofit organization may consider merging with another nonprofit organization that shares a common vision or purpose, or creating one or more subsidiary corporations, which together form a family of aligned entities.

State statutes typically contain specific rules about how mergers can be accomplished and what the corporate documentation of a merger must include. Mergers and acquisitions require a close examination of both entities' foundational documents and purposes to ensure proper compliance with the Internal Revenue Code and state statutes. Additionally, multi-entity structuring may involve a host of legal and practical considerations, such as risk management, tax planning, donor development, program expansion, and leadership capability.

Part 3: Till Death Do Us Part

No one lives forever, and the world has never seen an immortal organization. That said, many nonprofits continue for long periods of time, seemingly without end. But many other organizations come to a legal end. Indeed, it is possible that at some point something will cause the nonprofit to dissolve and wind up its affairs, and that should not necessarily cause dismay. Though a nonprofit may not live forever, the good it achieves just might!

Voluntary Dissolution

Perhaps due to a lack of resources, a completed objective, or transition to another organization’s operations (other than through merger), a nonprofit’s board of directors may decide that it is time to end the corporation. While a nonprofit can be dissolved through a voluntary, administrative, or judicial dissolution, a voluntary dissolution is often preferable - essentially as a controlled, board-directed “death.”

Voluntary dissolution requires the corporation, through its directors or members, to decide it is time to wind up and end the organization’s operations. Each state has its own governing statute in this regard, and certain states’ attorneys general may have some authority over the dissolution, depending on the type of organization. In general, a dissolving organization’s board or members must approve dissolution, pay all outstanding liabilities, distribute any remaining charitable assets appropriately, file of the articles of dissolution, notify potential creditors, and file final federal and state tax documents.

Administrative Dissolution

Administrative dissolution can also occur when the secretary of state takes action to dissolve a corporation because of an administrative default that the corporation fails to correct in a timely manner. For example, the Illinois nonprofit act provides for certain situations in which the secretary of state may initiate an administrative dissolution. However, an administratively dissolved corporation can be reinstated upon filing for reinstatement with the secretary of state and will be deemed to have continued during the dissolved period (except that officers and directors will not be liable for any debts or liabilities incurred by the corporation during that time). The risk associated with involuntary dissolutions stems from the entity’s typical lack of awareness that it has been dissolved. Absent such awareness, the organization may be operationally active, but without the protection of the corporate form. The simple and inexpensive annual task of filing an entity’s annual report to keep the corporation in good standing is therefore extremely significant.

Judicial Dissolution

Dissolution of a nonprofit corporation may be forced upon the organization by the Attorney General, a member or director of the organization, or other third party. This typically happens in cases of fraud, some insurmountable conflict within the organization, or the corporation cannot pay its debts.

State laws provide several options a nonprofit organization's leadership may consider when it has reached the end of its life cycle. Because nonprofit corporations are highly regulated, it is critical to consult governing state statutes to determine the best solution for your organization.

Onward

Our law firm is grateful to serve and advise nonprofit leaders as they navigate the endless combinations of scenarios and decisions of their nonprofit endeavors. Each nonprofit has the opportunity leave a remarkable impact on people and communities through their dedicated efforts. So, whether starting a new nonprofit entity, continuing the daily operations, evaluating transitional opportunities, and perhaps even contemplating legal "death," be encouraged about the good that can be accomplished through nonprofit life!

[1] For more information about corporate purpose statements, see our blog, Nonprofit Corporate Purpose Statements: Legal Compliance under 501(c)(3) and Effective Communications.

[2] For more information about bylaws, see our blog, Q&A: Nonprofit Bylaws.

[3] Note that different types of nonprofit organizations may need to file other IRS documentation, such as the IRS Form 1024 for Section 501(c)(7) social clubs and the IRS Form 8976 for Section 501(c)(4) social welfare organizations. For more information about the IRS Form 1023 application, see our blog, A Walk Through the IRS Form 1023: Applying for Section 501(c)(3) Recognition.

[4] For further guidance focusing on first minutes, see our blog, First Minutes: Taking the Nonprofit's Corporate Foundational Steps.

[5] For further guidance focusing on the initial stages of a nonprofit's development, see our blog, Starting a Nonprofit 501(c)(3).

[6] For more information, see our blog, Directors' and Officers' Duty of Care – Pay Attention and Take Responsibility!

[7] For more information, see our blog, Wearing the Right "Hat": the Duty of Loyalty.

[8] For more information, see our blog Staying True to Your Mission: The Duty of Obedience.

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