

Nonprofit Organizations: A Guide to Choosing Form*

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I. Introduction

The charitable sector is composed of many organizations with diverse activities and goals. One characteristic that these organizations generally share is federal income tax exemption under Section 501(c)(3). An organization may qualify for federal tax-exempt status only if it chooses one of three forms: charitable trust, nonprofit corporation, or unincorporated association. Although all three forms are available, little has been written to provide startup organizations with guidance on the legal distinctions among the forms and how each form may or may not meet their individual needs.

This Article will focus on the various factors that influence choice of form. It will address organizations that intend to qualify for exemption from taxation under Section 501(c)(3) and that are considering which of the allowable organizational forms will best suit their particular needs.¹

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¹ Section 501(a) provides exemption from taxation for organizations described in that Section unless such exemption is denied under Sections 502 or 503. I.R.C. § 501(a). All section references herein are to the Internal Revenue Code of 1986, as amended unless otherwise stated. Under Section 502, an organization is not exempt under Section 501 if it simply carries on a for-profit trade or business with all profits payable to one or more organizations under Section 501. I.R.C. § 502(a). Section 503 denies exemption to certain

The scope will be limited to those organizations that intend to qualify as public charities rather than as private foundations Section 509(a).²

Section 501(c)(3) describes the following exempt organizations:

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 which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.³

The statute's vague language with respect to the form of the organization is somewhat misleading. The definition does not require a specific form; however, as noted above, if a charitable organization wishes to apply for federal income tax exemption under Section 501(c)(3), it must choose to be a charitable trust, nonprofit corporation, or unincorporated association.⁴

This Article will first describe the three forms and discuss the commonalities of the forms. It will then address individual factors that are of particular concern to charitable

trusts related to employee benefit plans if the trusts engage in prohibited transactions. I.R.C. § 503. Section 503 is outside the scope of this Article.

² Section 509(a) defines a public charity by exclusion from the definition of private foundation. *See* I.R.C. § 509(a). Under the statute, an organization is a private foundation unless it rebuts that presumption by qualifying as an organization described in Section 170(b)(1)(A) (describing such institutional entities as churches, universities, and hospitals); by receiving a broad range of public support; or by qualifying as a "supporting organization," which is organized and operated solely for the benefit of another organization that has public-charity status. *Id.* § 509(a)(1)-(3). For a detailed discussion of private foundations, see generally Gail K. Neuharth, *A Primer on Private Foundations*, PROB. & PROP., Nov./Dec. 1998, at 33.

³ I.R.C. § 501(c)(3).

⁴ Although trusts are not listed in the statute, the terms "fund" and "foundation" include trusts. *Fifth-Third Union Trust Co. v. C.I.R.*, 56 F.2d 767, 768 (6th Cir. 1932). Similarly, the definition of corporation includes unincorporated associations for federal tax purposes. I.R.C. § 7701(a)(3).

organizations and how different treatment, if any, would occur based upon choice of form. The factors examined are (1) ease of formation, (2) organizational liability, (3) duties of management, (4) management liability, (5) insurance and indemnification, (6) volunteer liability, (7) regulation and oversight, (8) modification, (9) dissolution, (10) fundraising, (11) real property, and (12) commercial activities.

Although each of the factors will be examined individually, an organization must assess each factor in conjunction with the other factors and the implications of choice of form on the organization's particular circumstances. A conclusion about choice of form can then be drawn based upon the relative merits of each form for the particular organization.

II. The Organizational Forms

A. Charitable Trusts

According to the Restatement (Second) of Trusts, a charitable trust is defined as “a fiduciary relationship with respect to property arising as a result of a manifestation of an intention to create it, and subjecting the person by whom the property is held to equitable duties to deal with the property for a charitable purpose.”⁵ Trustees administer the trust in strict adherence to the trust instrument. Founders of a trust, however, have substantial flexibility in drafting the trust instrument.⁶

⁵ RESTATEMENT (SECOND) OF TRUSTS § 348 (1959).

⁶ As will be discussed in greater detail, a trust does not encounter the same bureaucratic obstacles as a nonprofit corporation because it is not a statutory entity, thus making it a more expedient form for organizations when time is of the essence in seeking tax exemption.

B. Charitable Corporations

A nonprofit corporation is an entity organized under state law and governed by its board of directors and its officers in conformance with its articles of incorporation and its bylaws.⁷ In some states the nonprofit corporation is formed under a separate nonprofit corporation law, which may be based in whole or in part on the Revised Model Nonprofit Corporation Act.⁸ Other states, such as Delaware, have no separate nonprofit corporation statute, so nonprofit corporations are organized under the general corporate law, or under a subsection of that law.⁹ The main distinction of a charitable corporation from a business corporation is the “nondistribution constraint,” which prohibits the distribution of net earnings to private shareholders or individuals.¹⁰

C. Charitable Unincorporated Associations

An unincorporated nonprofit association is defined as “an unincorporated organization, other than one created by a trust, consisting of [two] or more members joined by mutual consent for a common, nonprofit purpose.”¹¹ The impact of a decision to form as an unincorporated association will depend primarily upon whether an

⁷ Throughout this Article, the nonprofit corporation qualifying for tax exemption under Section 501(c)(3) will be referred to as “charitable corporation.”

⁸ *E.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW (McKinney 2002).

⁹ *E.g.*, DEL. CODE ANN. tit. 8 (2002).

¹⁰ Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 1990) (“[A]n organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.”). This concept has been labeled the “nondistribution constraint” by Professor Henry Hansmann. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838-40 (1980).

¹¹ UNIF. UNINCORPORATED NONPROFIT ASS’N ACT §1(2) (1996) (using brackets to identify language that may be readily modified for enactment). This definition is misleading in its simplicity, however, because for the purposes of qualifying for tax exemption under Section 501(c)(3), the I.R.S. has stated that “a formless aggregation of individuals without some organizing instrument, governing rules, and regularly chosen officials would not be a [tax-exempt charitable entity] for purposes of IRC 501(c)(3).” I.R.S., INTERNAL REVENUE SERVICE MANUAL § 7.25.3.2.3 (1999) (citing *Trippe v. Comm’r*, 9 T.C.M. (CCH) 622 (1950)). Throughout this Article, the unincorporated nonprofit association qualifying for tax exemption under Section 501(c)(3) will be referred to as “charitable unincorporated association.”

unincorporated association is formed under state common law or statutory law. Absent a statute specifically addressing the status of an unincorporated association, state common law governs. At common law, a charitable association is not considered a legal entity.¹² The common law, borrowing from partnership law, views a charitable association simply as an aggregate of its members, and members are considered co-principals of the association.¹³ As a consequence, a charitable unincorporated association under the common law is unable to hold real property, enter into contracts, or be held liable to its members or third parties.¹⁴

In 1996, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Unincorporated Nonprofit Association Act (the "Uniform Act"), a model act that sought to change the common law with respect to charitable unincorporated associations in three major areas by recognizing such organizations as separate legal entities that could be sued, enter into contracts, and hold real property.¹⁵ In addition, the Uniform Act provides procedures for disposition of a charitable association's property when it dissolves. In these areas of contract, organizational liability, and real property, the Uniform Act effectively treats charitable unincorporated associations similarly to charitable corporations. Therefore, some factors discussed in this Article will be greatly impacted by the distinction between associations organized under the common law and associations organized under the Uniform Act. As of the time of publication,

¹² ALA. CODE § 10-3B-7 cmt. 1 (2002).

¹³ *E.g., id.*; IDAHO CODE § 53-706 cmt. 1 (Michie 2002).

¹⁴ David Cullen, *Uniform Unincorporated Nonprofit Association Act: Security and Legality*, WIS. LAW., Oct. 1997, at 45.

¹⁵ UNIF. UNINCORPORATED NONPROFIT ASS'N ACT §§ 4, 6, 9. For a more in-depth discussion of the effect of the Uniform Act on the right of a charitable unincorporated association to hold property and be sued in tort or contract, see *infra* notes 186-96, 261-69 and accompanying text.

thirteen jurisdictions had adopted the Uniform Act in full or granted separate legal entity status to charitable associations.¹⁶ These thirteen jurisdictions are Alabama,¹⁷ Arkansas,¹⁸ California,¹⁹ Colorado,²⁰ Delaware,²¹ District of Columbia,²² Hawaii,²³ Idaho,²⁴ North Carolina,²⁵ Texas,²⁶ West Virginia,²⁷ Wisconsin,²⁸ and Wyoming.²⁹ Organizers of a charitable organization must consider whether the state chosen for formation has, in whole or in part, adopted the Uniform Act.

III. Commonalities Among Public Charities

Regardless of the form of the organization, all organizations seeking exemption from federal taxes under Section 501(c)(3) share certain characteristics because they all must meet standards set out in several statutory and judicial tests.³⁰ Under Section 501(c)(3), each organization qualifying for tax exemption must meet both an “organizational” and an “operational” test.³¹ The organizational test requires that the

¹⁶ Connecticut and Oklahoma introduced, but did not pass, bills to adopt the Uniform Act in their 2001-2002 Session. S. 628, 2002 Gen. Assem., Feb. Sess. (Conn. 2002); S. 609, 48th Leg., Reg. Sess. (Okla. 2001).

¹⁷ ALA. CODE §§ 10-3B-1 to -18 (2002).

¹⁸ ARK. CODE ANN. §§ 4-28-501 to -517 (Michie 2002).

¹⁹ CAL. CORP. CODE §§ 21000-21103 (West 2002); *White v. Cox*, 95 Cal. Rptr. 259 (Ct. App. 1971).

²⁰ COLO. REV. STAT. §§ 7-30-101 to -119 (2002).

²¹ DEL. CODE ANN. tit. 6, §§ 1901-1916 (2002).

²² D.C. CODE ANN. §§ 29-971.01 to -115 (2001).

²³ HAW. REV. STAT. §§ 429-1 to -13 (2002).

²⁴ IDAHO CODE §§ 53-701 to -717 (Michie 2002).

²⁵ N.C. GEN. STAT. ANN. § 58B (2006).

²⁶ TEX. REV. CIV. STAT. ANN. art. 1396-70.01 (Vernon 2002).

²⁷ W. VA. CODE §§ 36-11-1 to -17 (2002).

²⁸ WIS. STAT. §§ 184.01-.15 (2002).

²⁹ WYO. STAT. ANN. §§ 17-22-101 to -115 (Michie 2002).

³⁰ For practical and general information regarding this Section, see I.R.S., PUB. 557, TAX-EXEMPT STATUS FOR YOUR ORGANIZATION (rev. July 2001) [hereinafter I.R.S. PUB. 557]. In general, charitable organizations are also granted exemption from various state taxes. HOWARD L. OLECK & MARTHA E. STEWART, NONPROFIT CORPORATIONS, ORGANIZATIONS, & ASSOCIATIONS §§ 130-32, at 419-23 (6th ed. 1994). However, organizations must consult appropriate state statutes regarding the scope of tax exemption because it may vary from state to state.

³¹ Treas. Reg. § 1.501(c)(3)-1(b), (c).

organization be “organized exclusively” for one or more exempt purposes.³² Thus, the organizational documents must limit the purposes of that organization to one or more exempt purposes and must not expressly allow for activities, other than as an insubstantial part, that are not in furtherance of those exempt purposes.³³ This requirement includes the limitations articulated in Section 501(c)(3) regarding attempts to influence legislation³⁴ and participate in political campaign activities.³⁵ The organizational test also requires that

³² Exempt purposes are the following: religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals. Treas. Reg. § 1.501(c)(3)-1(d). An organization is not considered organized exclusively for one or more of these exempt purposes if it serves a private interest, rather than a public one. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

³³ Treas. Reg. § 1.501(c)(3)-1(b)(1)(i). An organization generally will start with a template document from legal counsel or other resources and tailor the provisions to meet its specific needs. There are many good resources with template documents for all three organizational forms. *E.g.*, STEVE BACHMANN, *NONPROFIT LITIGATION: A PRACTICAL GUIDE WITH FORMS AND CHECKLISTS* § 2.4, at 17-36 (1992); LAWYERS ALLIANCE FOR NEW YORK, *GETTING ORGANIZED* app. B (Allen R. Bromberger et al. eds., 5th ed. 1999); MARILYN PHELAN, *REPRESENTING NONPROFIT ORGANIZATIONS* app. 1-A to -D (1994). Organizations should consult state law, however, because statutory prerequisites for each organizational form may vary from state to state.

³⁴ An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it:

- (i) To devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise; or
- (ii) Directly or indirectly to participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.

Treas. Reg. § 1.50(c)(3)-1(b)(3). Public charities may rely on two tests to determine whether their legislative activities are permissible: the “no substantial part” test under Section 501(c)(3), which is a facts and circumstances test; or the “expenditure test” under Section 501(h), which provides a formula to determine the permissible extent of legislative activities. I.R.C. § 501(c)(3), (h). Organizations that intend to engage in substantial lobbying activities may wish to seek exemption under I.R.C. § 501(c)(4) or to form a second organization under that provision to separate out their legislative activities. Brent Coverdale, Comment, *A New Look at Campaign Finance Reform: Regulation of Nonprofit Organizations Through the Tax Code*, 46 U. KAN. L. REV. 155, 158-62 (1997). *See generally* BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* §§ 20.1-7, at 544-62 (8th ed. 2004) (discussing lobbying restrictions on 501(c)(3) and 501(c)(4) organizations).

³⁵ Treas. Reg. § 1.501(c)(3)-1(c)(3) (defining an organization that participates in political campaign activity as an action organization that is not operated exclusively for one or more exempt purposes and thus does not qualify under Section 501(c)(3) because it fails the “operational test”). In addition, Section 4955 imposes excise taxes on the political expenditures of a 501(c)(3) organization and prohibits the organization from reorganizing as a 501(c)(4) social welfare organization, which would not be subject to the same restrictions on political campaign activity. I.R.C. § 4955. Although the language of Section 501(c)(3) appears to completely ban political campaign activities, I.R.S. rulings have been inconsistent in defining the forbidden activity, allowing organizations to participate in voter registration drives and to provide a forum for candidates’ debate. *E.g.*, *Fulani v. League of Women Voters Educ. Fund*, 882 F.2d 621 (2d Cir. 1989); Rev. Rul. 86-95, 1986-2 C.B. 73; Tech. Adv. Mem. 91-17-001 (Sept. 5, 1990). For additional information, see

the organization’s governing documents—the trust instrument, corporate charter or certificate of incorporation, or articles of association—provide that the assets be distributed upon dissolution for one or more exempt purposes and not be distributed to the organization’s members or shareholders.³⁶

The operational test mandates that the organization “engage[] primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3).”³⁷

The operational test also prohibits activities that will result in inurement of the organization’s net earnings to “insiders.” Thus, this proscription generally forbids the transfer of an organization’s assets for non-exempt purposes to any person with financial control over the organization.³⁸

In addition to the organizational and operational tests, all organizations granted exemption from taxation under Section 501(c)(3), regardless of form, must be “charitable.” The Supreme Court refined the understanding of “charitable” in *Bob Jones University*, upholding the government’s denial of tax-exempt status for an educational

Joseph S. Klapach, Note, *Thou Shalt Not Politic: A Principled Approach to Section 501(c)(3)’s Prohibition of Political Campaign Activity*, 84 CORNELL L. REV. 504 (1999).

³⁶ Treas. Reg. § 1.501(c)(3)-1(b)(4). Revenue Procedure 82-2 provides guidance as to when an organization need not meet this dissolution test, and an example of acceptable dissolution provisions for organizations that are required to have an express provision. Rev. Proc. 82-2, 1982-1 C.B. 367.

³⁷ Treas. Reg. § 1.501(c)(3)-1(c)(1). See generally HOPKINS, *supra* note 34, § 4.5, at 82-86 (discussing the operational test); FRANCES R. HILL & DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS (Tax Series, 2002).

³⁸ Church of Scientology v. C.I.R., 823 F.2d 1310, 1316 (9th Cir. 1987). The following are examples of transactions that may cause organizations to be denied exempt status: (1) lending any part of the organization’s income or corpus without receipt of adequate security and reasonable rate of interest; (2) paying any compensation in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered; (3) making any part of its services available on a preferential basis; (4) selling any substantial part of its securities or other property for less than an adequate consideration; and (5) engaging in any transaction that results in a substantial diversion of its income or corpus to the organization’s creator, substantial contributors, family members, or controlled corporations of such persons. See also Gen. Couns. Mem. 39,862 (Nov. 21, 1991). In addition to jeopardizing exemption under Section 501(c)(3), these transactions can result in personal liability for excise taxes imposed on “disqualified persons” and

institution that discriminated on the basis of race.³⁹ The Court rejected the University's argument that having a purpose that falls into one of the eight categories set forth in 501(c)(3) was enough to guarantee tax exemption. The Court stated "that entitlement to tax exemption depends on meeting certain common law standards of charity – namely, that an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy."⁴⁰

If an organization meets all of the requirements of Section 501(c)(3) and wishes to obtain federal income tax exemption, it must notify the Internal Revenue Service that it is applying for Section 501(c)(3) status, unless excepted under Section 508(c) or by regulation.⁴¹ Exceptions from filing requirements are provided for churches and for any organization that is not a private foundation and that has gross receipts in each taxable year that do not normally exceed \$5000.⁴² Organizations notify the I.R.S. by filing a Form 1023, "Application for Recognition of Exemption," within 27 months from the end of the month in which the organization is formed.⁴³ If the application is filed within the prescribed period and approved, tax-exempt status will be recognized retroactively to the

"organization managers" under Section 4958. Henry A. Smith III, *The Intermediate Sanction Rules: A General Overview*, SF19, ALI/ABA 565.

³⁹ *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983). See generally MICHAEL HATFIELD ET AL., BOB JONES UNIVERSITY: DEFINING VIOLATIONS OF FUNDAMENTAL PUBLIC POLICY (Nat'l Ctr. on Philanthropy & the Law, Monograph No. 6, 2000) (discussing the impact of the *Bob Jones* decision), available at <http://www.law.nyu.edu/ncpl/library/publications/Monograph2000BobJones.pdf>.

⁴⁰ *Bob Jones Univ.*, 461 U.S. at 586.

⁴¹ I.R.C. § 508(a); Treas. Reg. §§ 1.508-1 to -4.

⁴² I.R.C. § 508(c). "Churches" include "interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church" (such as a men's or women's organization, religious school, mission society, or youth group). Treas. Reg. § 1.508-1(a)(3)(a). The regulation also exempts subordinate organizations that are covered by a group exemption letter. *Id.* § 1.508-1(a)(3)(c).

⁴³ Treas. Reg. § 1.508-1(a)(2). Organizations may be subject to additional filing requirements. See I.R.S. PUB. 557, *supra* note 30, at 2-4.

date of organization.⁴⁴ Late filing will result in recognition from the date of filing rather than inception unless the I.R.S. grants an exception.⁴⁵ Most organizations that qualify as charitable under Section 501(c)(3) also will be eligible to receive tax deductible contributions from individuals and corporations, thus making it easier for them to raise funds to support their exempt purposes.⁴⁶

Most organizations granted tax exemption by the I.R.S., regardless of form, must file an annual information return in order to justify continued federal tax-exempt status.⁴⁷ Exceptions to the annual filing requirement are made for specific organizations, such as churches,⁴⁸ and organizations whose annual gross receipts do not normally exceed \$25,000.⁴⁹ In addition, charitable organizations are subject to public disclosure requirements, including making copies of their applications for exemption and annual

⁴⁴ I.R.S. PUB. 557, *supra* note 30, at 16.

⁴⁵ *See id.*; BLAZEK, *supra* note 38, at 5.

⁴⁶ Section 170(c)(2) describes whether a charitable organization is eligible to receive tax-deductible contributions. However, the organizations that meet the criteria of 501(c)(3) or 170(c)(2) do not completely overlap. Therefore, contributions to some organizations, such as those that qualify for tax exemption under the category of testing for public safety, may not be tax deductible. *Compare* I.R.C. § 501(c)(3), *with* I.R.C. § 170(c)(2). Furthermore, Section 170(c)(2) limits the organization's use of funds outside of the United States. I.R.C. § 170(c)(2). For further information about foreign charity work, see generally JOANNIE CHANG ET AL., CROSS-BORDER CHARITABLE GIVING (Nat'l Ctr. on Philanthropy & the Law, Monograph No. 5, 1996), *reprinted in* 31 U.S.F. L. REV. 563 (1997); Harvey P. Dale, *Foreign Charities*, 48 TAX LAW. 655 (1995).

⁴⁷ I.R.C. § 6033(a). This information return is called a Form 990. Treas. Reg. § 1.6033-2(a)(2)(i). Depending on an organization's activities, the I.R.S. may require it to file additional forms, such as employment tax returns; a Form 8282 donee information return; or a Form 990-T, "Unrelated Business Income Tax Return," if the organization has \$1000 or more gross income from an unrelated business. I.R.S. PUB. 557, *supra* note 30, at 7.

⁴⁸ Treas. Reg. § 1.6033-2(g).

⁴⁹ I.R.S., INSTRUCTIONS FOR FORM 990 AND FORM 990-EZ 2 (2002). An organization is considered to have gross receipts of less than \$25,000 if it passes the following test: (1) the organization is less than one year old and has received (or donors have pledged) \$37,500 or less; or (2) the organization is between one and three years old and has received an average of \$30,000 or less per year for each of the first two years; or (3) the organization is older than three years and has received an average of \$25,000 or less for each of the three immediately preceding years (including the year in which the return is to be filed). *Id.* at 3. For additional information regarding the Form 990, see generally Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits*, 51 TAX LAW. 571 (1998).

information returns available to the public for inspection at the organization's offices and providing copies of those documents to the public upon request.⁵⁰

IV. Formation

Some organizations may need to form quickly. Accordingly, speed of formation may be a relevant factor in a choice of form decision, as several hypothetical examples may indicate. For example, assume that a group of parents and community leaders join together to form an "After-school Program for Kids" in an effort to provide a safe place for children in the community to play and learn after school. Assume further that a donor promises the group a gift of a building where the after-school program can be housed. In that case, the founding parents and community leaders must have some entity in place to accept the gift. Another hypothetical example might be an organization formed by a group of concerned citizens, called "Save the Wetlands," that intends to prevent local developers from building on a particular piece of wetland. In order to save the wetland from development, the concerned citizens must organize quickly to raise the funds necessary to purchase the land before it is developed.

In some states, charitable unincorporated associations and charitable trusts may be formed with greater speed and flexibility than charitable corporations because those forms are subject to fewer state statutory requirements and require fewer approvals. For example, in New York, an organization seeking to incorporate under the New York Not-for-Profit Corporation Law may need to submit its articles of incorporation to various state agencies for pre-approval or consent, depending on the charitable activities that the corporation intends to conduct, before filing the articles with the Secretary of State to

⁵⁰ I.R.C. § 6104; Treas. Reg. §§ 301.6104(a)-1 to (d)-3.

begin corporate existence.⁵¹ There is no corresponding requirement under New York state law for charitable unincorporated associations or charitable trusts. The pre-approval process may significantly impact an entity's choice of organizational form because it could create a substantial hurdle for organizations that need to form quickly.⁵²

Organizations such as “After-school Program for Kids” and “Save the Wetlands” may wish to form as a charitable trust or charitable unincorporated association, if located in a state that allows charitable unincorporated associations to hold property.⁵³ Those forms may be appropriate because, under the assumed facts, those organizations need to be formed quickly in order to carry out their charitable purpose. Alternatively, such organizations could incorporate in a state, such as Delaware, that does not have burdensome regulatory requirements and then file any necessary application to do business in the state or states where the organizations will be located or primarily operated. Ultimately, however, time should not dictate organizational form because an entity could begin its existence as a charitable trust or charitable unincorporated association and later reorganize as a charitable corporation.⁵⁴

V. Management Structure and Duties of Management

Management of a charitable organization usually is entrusted to a governing body. The fiduciary duties of that governing body and its members depend on the form of the

⁵¹ For example, approvals may be required from the commissioners of social services, health, or education or the attorney-general. *E.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW § 404 (McKinney 2002); *see also* VICTORIA B. BJORKLUND ET AL., NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS § 3.7, at 49-58 (1997).

⁵² BJORKLUND, *supra* note 51, § 1.3, at 11, 14.

⁵³ *See infra* notes 261-69 and accompanying text. In addition, because it has a finite purpose to purchase particular land, “Save the Wetlands” must consider its desire to dissolve or change its purpose when choosing an organizational form.

⁵⁴ *See* JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES & MATERIALS 67 (3d ed. 2006); *see also* HOPKINS, *supra* note 34, § 24.1(b), at 657-58.

organization. Failure to fulfill those duties may result in personal liability for governing body members to the organization or to third parties.⁵⁵

A. Duties of Trustees in a Charitable Trust

A charitable trust is governed by its trustees in strict accordance with its trust instrument. The trust instrument, however, can provide flexibility and remove many of the strict default rules discussed below.⁵⁶ The main duties of a charitable trustee are the duty of care, which requires the trustee to exercise the care and skill that an ordinary prudent person would exercise in dealing with his or her own property,⁵⁷ and the duty of loyalty, which requires the trustee to administer the trust solely in the interests of the beneficiaries, to deal fairly with the beneficiaries, and to communicate all material facts to the beneficiaries.⁵⁸ Other duties include the trustee's duty to maintain separate accounts for his or her own property and for trust property,⁵⁹ to delegate only those responsibilities that a prudent person might delegate to others,⁶⁰ and to diversify investments and manage

⁵⁵ There are surprisingly few cases involving fiduciary breaches in the context of charitable organizations. Famous examples are the United Way and Adelphi University cases. See Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 633-36 (1998).

⁵⁶ See Arthur B. Page, *Choice of Entity and Incorporation*, NPOI MA-CLE 1-I § 1.4.2(a) (1998).

⁵⁷ RESTATEMENT (SECOND) OF TRUSTS § 174 (1959); see also *In re Conservatorship of Estate of Martin*, 421 N.W.2d 463, 464 (Neb. 1988); *City of Philadelphia Bd. of Revision of Taxes v. Elkins*, 312 A.2d 806, 809 (Pa. Commw. Ct. 1973). "Whether the trustee is prudent in the doing of an act depends upon the circumstances as they reasonably appear to him at the time when he does the act and not at some subsequent time when his conduct is called into question." RESTATEMENT (SECOND) OF TRUSTS § 174 cmt. b; see also *In re Estate of Kugler*, 344 N.W.2d 160, 165 (Wis. 1984).

⁵⁸ RESTATEMENT (THIRD) OF TRUSTS § 170 (1990). There is an absolute prohibition against trustee self-dealing, covering such actions as the trustee borrowing trust monies, leasing land held in the trust, or investing trust funds in his or her own business. *Id.* cmt. l; see also *Grynberg v. Watt*, 717 F.2d 1316, 1319 (10th Cir. 1983); *Mercury Bay Boating Club Inc. v. San Diego Yacht Club*, 557 N.E.2d 87, 95 (N.Y. 1990).

⁵⁹ RESTATEMENT (SECOND) OF TRUSTS § 179; see also *Prof'l Helicopter Pilots Ass'n v. Denison*, 804 F. Supp. 1447, 1452 (M.D. Ala. 1992).

⁶⁰ RESTATEMENT (THIRD) OF TRUSTS § 171.

A trustee's discretionary authority in the matter of delegation may be abused by imprudent failure to delegate as well as by making an imprudent decision to delegate. Abuse of discretion may also be found in failure to exercise prudence in the degree or manner of delegation. Prudence thus

trust assets prudently.⁶¹

1. Duty of Care

The trustee of a charitable trust is required to perform his or her duties with the same degree of skill and care a prudent person would demonstrate when dealing with his or her own property. This duty results in trustee liability for mere negligence in the performance of duties or even for failure to act with respect to trust property,⁶² which sets a higher standard of care for charitable trustees than for directors of charitable corporations. The standard of care requires that every trustee act as a prudent person regardless of his or her level of skill. In addition, a trustee with a greater degree of skill than an ordinary prudent person must use that skill, or the trustee will be liable for any loss that results from failure to fully utilize the specialized skill.⁶³ For example, a trustee who is a professional financial advisor would be held to a higher standard in the investment of trust assets than an ordinary trustee.

requires the exercise of care, skill, and caution in the selection of agents and in negotiating and establishing the terms of delegation. Significant terms of a delegation include those involving the compensation of the agent, the duration and conditions of the delegation, and arrangements for monitoring or supervising the activities of agents.

Id. cmt. a; *see also* Donaldson v. Borough of Madison, 213 A.2d 33, 39 (N.J. Super. Ct. Ch. Div. 1965). At common law, trustees were not able to delegate any authority or responsibility. James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 402 (1987). By changing common law, the Restatement places the charitable trustee in a situation similar to a charitable corporation's director, who has the ability to delegate responsibility. However, the standard used to measure whether delegation by the trustee was prudent may be higher than the standard used to judge a director's delegation of responsibility.

⁶¹ RESTATEMENT (THIRD) OF TRUSTS § 227; *see also* *In re* Will of Maxwell, 704 A.2d 49, 60-61 (N.J. Super. Ct. App. Div. 1997). The Uniform Prudent Investor Act provides guidelines for charitable trustees to follow in investing and managing trust assets. UNIF. PRUDENT INVESTOR ACT §§ 1-9 (1994). Organizations must remember, however, that the trust instrument will govern the duties and powers of the trustees; therefore, the rules under the Prudent Investor Act may be expanded or limited by the trust terms. *Id.* § 1(b).

⁶² Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1428 (1998); Fishman, *supra* note 60, at 402.

⁶³ RESTATEMENT (SECOND) OF TRUSTS § 174 cmt. a.

Although a trustee is theoretically held to a higher standard of care, the corporate form is not necessarily more advantageous on this point. First, as noted above, an advantage of the charitable trust is the drafter's flexibility to create the terms of the trust. In practice, founders can draft the trust instrument with a lower standard of care for the trustee, thus placing the trustee on par with the corporate director.⁶⁴

Second, some founders may wish for the governing members to be held to a higher standard of care as a way of ensuring that the members strictly adhere to the charity's mission. For example, the charitable trust form may be attractive to the building owner who wishes to donate it to the After-school Program for Kids. The donor is gifting a large asset and may wish to ensure that the decisions of the governing members are consistent with the purposes outlined prior to donation.

2. Duty of Loyalty

The duty of loyalty requires that the trustee refrain from engaging in any dealings with the trust ("self-dealing").⁶⁵ Examples of self-dealing include a trustee's personal use of trust property, investment of trust funds in a corporation in which the trustee is a principal shareholder,⁶⁶ and pledge of trust property as collateral to guarantee a loan for the trustee or the trustee's business interests.⁶⁷ In contrast to the charitable corporation's statutory

⁶⁴ Brody, *supra* note 62, at 1423, 1428; *see also* MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT at 433 (1965) ("It is the rare trust instrument which does not include some, if not all, of the provisions whereby these differences between trustees and directors are removed"). The distinction between the standard of care for trustees and for directors remains an important one for uninformed founders or founders who do not draft the trust instrument carefully enough to ensure that the trustees are held to a more lenient standard than otherwise imposed by law.

⁶⁵ Fishman, *supra* note 60, at 433. This prohibition also applies to transactions between the trustee in his capacity as such and his family members or a corporation in which he owns a significant interest.

⁶⁶ Kinney v. Lindgren, 26 N.E.2d 471, 474 (Ill. 1940).

⁶⁷ *See* California v. Larkin, 413 F. Supp. 978, 982 (N.D. Cal. 1976).

authority to allow an interested transaction before or after it has been consummated as long as the transaction is fair or to the benefit of the corporation,⁶⁸ the restraint on self-dealing by a trustee is traditionally an absolute prohibition. However, there are three ways to mitigate this prohibition with respect to charitable trusts.⁶⁹ First, as with the duty of care, the trust instrument may waive the prohibition and allow interested transactions as long as it is fair to the trust.⁷⁰ Second, a trustee may seek court approval before entering into any transaction with the trust.⁷¹ Lastly, even if the prohibition remains, the interested transaction may not be voided if either the self-dealing resulted in gain to the trust or the trustee agrees to restore any loss. The last option does not protect the trustee from breach-of-loyalty claims; however, it does benefit the trust, which retains any profits from the self-dealing transaction.⁷²

B. Duties of Directors and Officers in Charitable Corporations

A charitable corporation is governed by its board of directors and its officers. The articles of incorporation may state the number of directors and designate initial directors, although in some cases state law mandates a minimum number of directors.⁷³ The directors are responsible for appointing a president, secretary, treasurer, as well as other corporate officers that the board chooses to create.⁷⁴ The powers and responsibilities of

⁶⁸ REV. MODEL NONPROFIT CORP. ACT § 8.31 (1987).

⁶⁹ *Id.* at 1420; *see also* Kerper v. Kerper, 780 P.2d 927, 929-30 (Wyo. 1989) (refusing to impose liability on a trustee who had made loans to herself where the trust provisions limited liability if the trustee acted in good faith and noting that the trust's good-faith standard supersedes the reasonably prudent person standard and the prohibition on self-dealing transactions).

⁷⁰ *E.g.*, *In re* Estate of Stevenson, 2000 SD 24, ¶¶ 15-17, 605 N.W.2d 818, 822.

⁷¹ *E.g.*, IOWA CODE § 633.155 (2002); *In re* Guardianship & Conservatorship of Jordan, 616 N.W.2d 553, 558-59 (Iowa 2000); *see also* Fishman, *supra* note 60, at 434 n.179.

⁷² *See* Brody, *supra* note 62, at 1420; *see also* Fishman, *supra* note 60, at 434 n.179.

⁷³ REV. MODEL NONPROFIT CORP. ACT § 2.02(b)(2), (3) (1987).

⁷⁴ *See id.* § 8.40(a).

the directors and officers are stated in the bylaws. State law (statutory or common) also imposes fiduciary standards of care and loyalty on charitable directors and officers.⁷⁵ States have created legal protections for directors and officers that meet the fiduciary standards because the states recognize that directors and officers cannot be held liable for every decision made on behalf of the charitable corporation. This Article focuses on the RMNCA's approach to the fiduciary duties of directors and officers.

1. Duty of Care

The standards of care for directors of charitable corporations are either explicitly stated in state statutes governing nonprofit corporations, state statutes governing corporations (including non-stock corporations), or the state common law. State approaches to charitable standards of care can be grouped into three categories. Some states hold charitable directors and officers to the same standard as charitable trustees.⁷⁶ Other states hold charitable directors and officers to a lesser standard, fearing that liability will discourage individuals from assuming the responsibilities of a director or officer of a

⁷⁵ Fishman, *supra* note 60, *passim*; *Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1592 (1992) [hereinafter *Developments*]; *cf.* Daniel L. Kurtz, *The Duties and Liabilities of Officers and Directors, Including a Review of Indemnification and Insurance*, 307 PLI/TAX 431 (1990). Kurtz argues that a third fiduciary duty exists—the duty of obedience—that requires directors to carry out the purposes of the organization as expressed in their charter or by-laws and ensures that the charitable organization conducts its activities lawfully. Kurtz contends that the duty of obedience prevents directors from acting outside the realm of their original purpose without seeking some formal legal approval for a modification to the original purpose.

⁷⁶ Pennsylvania, for example, holds charitable directors to the same standard as charitable trustees based on the view that charities hold property in trust. 15 PA. CONS. STAT. ANN. § 5547(a) (West 2002); *cf.* Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) (refusing to apply the trustee standard to charitable directors) (“The founder of a charitable trust binds its funds by the express limitations and conditions of the trust document and imposes upon its trustees the strict and unyielding principles of trust law. By contrast, the founder of a charitable corporation makes a gift ‘outright to the corporation to be used for its corporate purposes’ and invokes the far more flexible and adaptable principles of corporate law.”) (citing *Denckla v. Independence Found.*, 193 A.2d 538, 541 (Del. 1963)).

charitable corporation.⁷⁷ Finally, some states hold directors and officers of nonprofit corporations to the same standard as directors and officers of for-profit corporations, which may or may not be the same standard as a charitable trustee.⁷⁸

The RMNCA's approach incorporates many elements of various state laws and adopts a standard of care similar to the standard of care applied to the for-profit sector.⁷⁹ The RMNCA requires directors (and officers with discretionary authority) to discharge their duties "in good faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director reasonably believes to be in the best interests of the corporation."⁸⁰ In discharging his or her duties, a director (or officer with discretionary authority) is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, provided by parties such as the officers, employees, and legal counsel of the charitable corporation.⁸¹ However, a director (or officer with discretionary authority) must exercise

⁷⁷ *E.g.*, *George Pepperdine Found. v. Pepperdine*, 271 P.2d 600, 604-05 (Cal. Dist. Ct. App. 1954); *see also* Lizabeth Moody, *State Statutes Governing Directors of Charitable Corporations*, 18 U.S.F. L. REV. 749, 754 n.19 (1984).

⁷⁸ States that apply the for-profit standard to nonprofit directors and officers include Georgia, *compare* GA. CODE ANN. § 14-3-830 (2002) (describing standard for nonprofit directors), *with id.* § 14-2-830 (for-profit directors); Michigan, *compare* MICH. COMP. LAWS ANN. § 450.2541 (West 2002) (nonprofit directors), *with id.* § 450.1541a (for-profit directors); New Jersey, *compare* N.J. STAT. ANN. § 15A:6-14 (West 2002) (nonprofit directors), *with id.* § 14A:6-14 (for-profit directors); New York, *compare* N.Y. NOT-FOR-PROFIT CORP. LAW § 717 (McKinney 2002) (nonprofit directors), *with* N.Y. BUS. CORP. LAW § 717 (for-profit directors); and Ohio, *compare* OHIO REV. CODE ANN. § 1702.30(B) (Anderson 2002) (nonprofit directors), *with id.* § 1701.59(B) (for-profit directors).

⁷⁹ *See* Kurtz, *supra* note 75, at 439; *see also* Thomas H. Boyd, Note, *A Call to Reform the Duties of Directors Under State Not-For-Profit Corporation Statutes*, 72 IOWA L. REV. 725, 742 (1987).

⁸⁰ REV. MODEL NONPROFIT CORP. ACT §§ 8.30(a), 8.42(a) (1987).

⁸¹ *Id.* §§ 8.30(b), 8.42(b). The RMNCA allows directors and officers to rely on others "because board effectiveness and performance are maximized when the full board relies on others (a committee, officers or outside experts) to collect and evaluate information and/or to act for it in particular instances." *See* Kurtz, *supra* note 75, at 444; *cf.* *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1014 (D.D.C. 1974) ("A director who fails to acquire the information necessary to supervise investment policy or consistently fails even to attend the meetings at which such policies are considered has violated his fiduciary duty to the corporation. While a director is, of course, permitted to

reasonable care in delegating responsibility before the director or officer may rely on information provided and opinions given by others.⁸²

To assess whether a director or officer fulfilled his or her duty of care, the RMNCA focuses on the manner in which a decision was made rather than the correctness of the decision itself. The business judgment rule,⁸³ set out in section 8.30(d) of the RMNCA, protects the decisions of directors and officers that are made in good faith and with diligence, care, and attention.⁸⁴ Before applying the business judgment rule to protect a decision, courts look for evidence that the director or officer had sufficient information to make a decision, that she critically evaluated that information, and that she diligently made the decision.⁸⁵ Therefore, as distinguished from the mere negligence standard for charitable trustees, the business judgment rule creates a gross negligence standard for directors and officers of charitable corporations.⁸⁶

Compared to the higher standard of care for charitable trustees, the default standard of care for charitable corporations may make the corporate form more attractive

rely upon the expertise of those to whom he has delegated investment responsibility, such reliance is a tool for interpreting the delegate's reports, not an excuse for dispensing with or ignoring such reports." (citation omitted)).

⁸² REV. MODEL NONPROFIT CORP. ACT §§ 8.30(b), 8.42(b).

⁸³ In the context of charitable corporations, the business judgment rule may be referred to as the best judgment rule. See FISHMAN & SCHWARZ, *supra* note 54, at 168-69.

⁸⁴ The business judgment rule derives from for-profit corporation law, *Smith v. Van Gorkam*, 488 A.2d 858, 872-73 (Del. 1985) (discussing the business judgment rule in the for-profit context), but it has been applied to charitable organizations, *John v. John*, 450 N.W.2d 795, 801-02 (Wis. Ct. App. 1989); *Johnson v. Johnson*, 515 A.2d 255, 264-65 (N.J. Super. Ct. Ch. Div. 1986). Some commentators argue that the business judgment rule should not apply to charitable organizations because it is premised on the belief that businesses perform well economically when directors have some freedom to act without critical evaluation of their decisions, and this rationale does not apply in the context of the nonprofit corporation. *E.g.*, Kurtz, *supra* note 75, at 447. For a discussion of the soundness of the policy of applying the business judgment rule to charitable directors and officers, see Goldschmid, *supra* note 55, at 641-46.

⁸⁵ *E.g.*, *Smith*, 488 A.2d at 872.

⁸⁶ *Stern*, 381 F. Supp. at 1013; see also Carolyn C. Clark & Glenn M. Troost, *Forming a Foundation: Trust vs. Corporation*, PROB. & PROP., May/June 1989, at 32, 33-34.

to organizations that desire more flexibility in management responsibilities and delegation. For example, a wealthy donor, who is interested in supporting local artists and playwrights, may wish to start a hypothetical organization called “Art Theater,” where local works can be displayed and produced, by donating a large sum of money and receiving contributions from others. The donor may prefer to retain a large degree of control over the organization, but at the same time, not intend to be involved in the day-to-day management. To avoid breaching the duty of care, the founder of Art Theater may choose to incorporate so that she can delegate decisions in good faith to those individuals that run the organization on a daily basis.

2. Duty of Loyalty

The duty of loyalty requires directors to adhere faithfully to the charitable corporation’s mission and prohibits directors from improperly entering into transactions to gain personal benefit at the expense of the corporation.⁸⁷ However, a director may engage in transactions in which he or she has a personal interest if such interested transactions are approved by the board of directors pursuant to a conflict-of-interest policy.⁸⁸ It is less important whether a director has an interest in the transaction than

⁸⁷ REV. MODEL NONPROFIT CORP. ACT §§ 8.31-8.33. No section of the RMNCA discusses the duty of loyalty for corporate officers. Examples of self-interested transactions include personally taking an opportunity that has been offered to the charitable corporation before the board considers the offer, selling or leasing property to the corporation at unfavorable cost to the corporation, or serving as a director on the board of two organizations that are competing for funds from a single source. 1 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 4-1, at 132 (5th ed. 1993); Fishman, *supra* note 60, at 423-32.

⁸⁸ REV. MODEL NONPROFIT CORP. ACT § 8.31(b). The RMNCA provides a process for approving interested transactions before or after they are consummated. A board of directors or committee of the board may approve a transaction in advance by vote of a majority of disinterested directors if “[1] the material facts of the transaction and the director’s interest are disclosed or known to the board or committee of the board; and [2] the directors approving the transaction in good faith reasonably believe that the transaction is fair to the corporation.” *Id.* A transaction may also be approved before or after it is consummated by obtaining the

whether the transaction was fair to the corporation at the time the decision was made or whether the decision was approved by an impartial board.⁸⁹

Many states have statutes or common law that provide a procedure for approving interested transactions.⁹⁰ In general, states follow a procedure similar to that outlined in the RMNCA, requiring that material facts be disclosed and disinterested directors approve the transaction.⁹¹

In several states, courts look to the general corporate code for guidance on how charitable corporations may approve interested transactions without a breach of the duty of loyalty.⁹² Some courts require greater disclosure from directors of charitable corporations than for-profit directors.⁹³ Organizations must be aware of the necessary procedures in the chosen state to legitimize interested transactions because there are circumstances when a charitable corporation may wish to enter into a transaction with an officer or director. For example, instead of donating a building to After-school Program for Kids, the donor may wish to lease the space at a reduced cost. Even if the lease may be in the corporation's best interests, the lease should be subjected to the organization's conflict-of-interest policy, the director's interest should be disclosed, and the lease should be approved by disinterested directors because of the business relationship formed

approval of the attorney-general. *Id.* The RMNCA, however, absolutely prohibits charitable corporations lending money to or guaranteeing the obligations of a director or officer. *Id.* § 8.32(a).

⁸⁹ Fishman, *supra* note 60, at 423.

⁹⁰ FISHMAN & SCHWARZ, *supra* note 54, at 202.

⁹¹ *Id.*

⁹² *Id.* For further information on conflicts of interest and several examples of potential conflict-of-interest policies that organizations could include in their organizational documents, see Daniel L. Kurtz, *How to Manage Conflicts of Interest*, 369 PLI/TAX 7 (1995).

⁹³ *E.g.*, Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003, 1014-16 (D.D.C. 1974); Eurich v. Korean Found., Inc., 176 N.E.2d 692, 699-700 (Ill. App. Ct. 1961); Fowle Mem'l Hosp. Co. v. Nichols, 126 S.E. 94, 97 (N.C. 1925); Gilbert v. McLeod Infirmary, 64 S.E.2d 524, 529-31 (S.C. 1951).

between a director and the corporation. Although this process may seem cumbersome, it is important to note that if the organization had been formed as a charitable trust and the donor served as a trustee, the transaction could not take place at all, unless the situation fell within one of the three exceptions to the prohibition on self-dealing.⁹⁴

C. Duties of Governing Members in Unincorporated Associations

An unincorporated association is governed by its members consistent with its organizational documents and in accordance with agency principles.⁹⁵ Because it is difficult to define a single standard of care for the abundant variety of unincorporated associations, the Uniform Act has no governance provisions.⁹⁶ Furthermore, as previously noted, few states have statutory provisions that regulate charitable unincorporated associations. Therefore, it is unclear what standards of care and loyalty will be applied to members. Jurisdictions could adopt a governance provision similar to that adopted by Alabama, which sets a standard of care similar to the RMNCA provision and holds members of charitable unincorporated associations to the same level of care as governing members of other charitable forms.⁹⁷ Organizations that desire a more reliable standard of

⁹⁴ See *supra* notes 65-72 and accompanying text.

⁹⁵ See FISHMAN & SCHWARZ, *supra* note 54, at 140; Page, *supra* note 56, § 1.6.2 (“The charter of an association functions as a contract binding the members and the association to its terms . . . questions of control, management and membership will be governed by the terms of the charter.”).

⁹⁶ The Uniform Act attempted to develop default governance rules but noted “the complexity and difficulty of fashioning rules that would reasonably fit a wide variety of nonprofit associations – large and small, public benefit, mutual benefit, and religious, and of short and indefinite duration.” UNIF. UNINCORPORATED NONPROFIT ASS’N ACT § 2 cmt. 3. Therefore, the Uniform Act demurred to other sources of law while still recognizing that rules of governance must exist in order to achieve the purposes of the Uniform Act. *Id.* cmts. 2, 3.

⁹⁷ Compare REV. MODEL NONPROFIT CORP. ACT §§ 8.30, 8.42 (1987), with ALA. CODE § 10-3B-4(c) & cmt. 4 (2002) (“A member acting on behalf of the association shall discharge his or her duties in a manner the member reasonably believes to be in the best interests of the association.”). The Alabama statute also states that a “nonprofit association may adopt written rules for its regulation, management, governance and dissolution,” and for any matters not described by those written rules, the statute mandates that

governance, however, may wish to incorporate (especially in a state that follows the RMNCA), or, at the very least, adopt a comprehensive charter and bylaws detailing the management structure and fiduciary obligations of the members and governing body of the charitable unincorporated association.

VI. Management Liability

Many organizations will be concerned about the potential liability of governing members in choosing the form of organization.⁹⁸ Members of a charitable organization's governing body could be liable for acts or omissions in their capacity as governing members. In addition, governing members may be liable for the acts or omissions of other governing members or of the organization itself, depending on the circumstances. This Section addresses the liability of the governing body for breach of fiduciary duties, breach of contract, and tortious conduct based on choice of form.⁹⁹

Any protection for governing members of a charitable organization will be set out in state statutory law, but states have not taken uniform action as to the degree of protection afforded to management of charities.¹⁰⁰ However, state law rarely offers protection from liability to governing individuals who have breached fiduciary duties.¹⁰¹ It

(1) [a] member of a [charitable] association shall be entitled to participate in the governance of the association. A majority of the votes cast on a matter by members present and voting at a properly called meeting shall govern as to that matter[; and] (2) [a]s to any matter not determined by vote, the association may take action in accordance with its settled practices.

Id. As of 1998, no other state had added such a provision to its adoption of the Uniform Act.

⁹⁸ This Section does not address state and federal protections from liability for volunteers of charitable organizations. Because most governing members are uncompensated, they may also be "volunteers" for purposes of state and federal protections. Section VII of this Article addresses volunteer liability and notes how state or federal volunteer protections affect management liability.

⁹⁹ Section VIII discusses additional protections available to all organizational forms, such as insurance and indemnification.

¹⁰⁰ *Developments, supra* note 75, at 1685. The common-law doctrine of charitable immunity, discussed in detail later, only applies to charitable organizations, not the governing bodies. *Id.*

¹⁰¹ *See Kurtz, supra* note 75, at 455.

is settled that the attorney-general, as the representative of the public interest, may bring a suit against the governing body of a charity, either individually or as a whole, for breach of a fiduciary duty.¹⁰² Some state courts also recognize a private right of action for interested third parties, such as beneficiaries, to sue for breach of fiduciary duties.¹⁰³ Although historically few such suits have been brought, potential managers of charities should note the circumstances under which personal liability could attach.¹⁰⁴

A. Liability of the Charitable Trustee

As described above, the charitable trustee owes various duties to the trust including duties of care and loyalty. A charitable trustee who breaches a fiduciary duty commits a breach of trust¹⁰⁵ and incurs liabilities similar to a private trustee who breaches a fiduciary duty.¹⁰⁶

Much of a trustee's potential liability stems from her duty with respect to the investment of trust assets. First, the trustee is liable for any loss to the trust from an

¹⁰² Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 42 (1993); John A. Edie, *Directors, Officers, and Trustees Liability – Insurance and Indemnification*, C343 ALI-ABA 287, 297 (1988).

¹⁰³ E.g., *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 367 F. Supp. 536, 540 (D.D.C. 1973); *In re Green Charitable Trust*, 431 N.W.2d 492 (Mich. Ct. App. 1988); *Grey v. St. Matthew's Cathedral Endowment Fund, Inc.*, 544 S.W.2d 488, 490-91 (Tex. Civ. App. 1976); see also Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 673-76 (1998); Blasko, *supra* note 102, at 52.

¹⁰⁴ The lack of suits may be attributed to limited standing, an overcommitted state attorney-general, and the more lenient standards applied by courts sympathetic to charitable volunteers. See Harvey Dale, *Advising Directors and Trustees on Risks and Opportunities*, C875 ALI-ABA 57, 72-75 (1993).

¹⁰⁵ RESTATEMENT (SECOND) OF TRUSTS § 201 (1959) ("Ordinarily a trustee does not commit a breach of trust if he does not intentionally or negligently do what he ought not to do or fail to do what he ought to do. In other words, he does not commit a breach of trust unless he is personally at fault."); see also 3 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 201, at 219 (4th ed. 1987).

¹⁰⁶ RESTATEMENT (SECOND) OF TRUSTS § 386; see also 4A SCOTT & FRATCHER, *supra* note 105, § 386, at 340-41. Charitable trustees are subject to liabilities similar to those of a private trustee because the duties owed to the trust are similar. *State v. Taylor*, 362 P.2d 247, 250 (Wash. 1961).

improper investment.¹⁰⁷ Second, the trustee is obliged to restore any value to the trust resulting from misdirected, improperly distributed, or misappropriated funds.¹⁰⁸ Third, the trustee is liable for any failure to invest trust assets.¹⁰⁹ In addition, the trustee may not receive any personal benefit from the use of trust property. If the trustee receives any personal benefit from use of the trust, she must not only restore any loss in the value of the trust property but also return any personal profit made by the trustee through the breach of trust or any profit that would have accrued to the trust if the breach had not occurred.¹¹⁰

With all the fiduciary duties imposed on charitable trustees, concerns about personal liability for governing members may discourage some organizations from forming as charitable trusts. Utilizing the strict trust standard of care would subject the charitable trustee to a higher risk of personal liability for breach of fiduciary duties because liability attaches for acts of mere negligence in contrast to the gross negligence standard applied to acts of charitable directors under the business judgment rule.¹¹¹ Although the trust instrument may alter and relax the standard of care and the skill required of the trustee,¹¹² the greater certainty of the corporate standard and the protection of the business judgment rule make the corporate form more attractive to members of an organization's governing body with liability concerns. Further, in states where a specific statute governs the

¹⁰⁷ RESTATEMENT (SECOND) OF TRUSTS § 205; *see also* 4A SCOTT & FRATCHER, *supra* note 105, § 386, at 340-41.

¹⁰⁸ RESTATEMENT (SECOND) OF TRUSTS § 205; *see also* *Stuart v. Cont'l Ill. Nat'l Bank & Trust Co.*, 369 N.E.2d 1262, 1272 (Ill. 1977).

¹⁰⁹ 4A SCOTT & FRATCHER, *supra* note 105, § 386, at 341.

¹¹⁰ RESTATEMENT (SECOND) OF TRUSTS §§ 205, 206.

¹¹¹ *Supra* note 86 and accompanying text.

¹¹² *Supra* note 64 and accompanying text.

charitable corporation, directors generally can follow statutorily mandated procedures to avoid liability for actions taken on behalf of the corporation.

Charitable trustees also have a greater risk of personal liability for breach of contract than corporate directors because the trustee, not the trust, is considered the contracting party. A trustee is subject to personal liability for breach of any contract that the trustee enters into on behalf of the trust.¹¹³ Exceptions to this rule exist where the contract explicitly states that the trustee will not be exposed to personal liability¹¹⁴ or where the trustee did not participate personally in the making of the contract.¹¹⁵ In addition, a trustee may be entitled to reimbursement from trust assets for any expenses associated with a breach of contract if the expenses were legitimate trust expenses.¹¹⁶

A trustee incurs personal liability for torts committed in the administration of the trust only if she was personally at fault, regardless of the injured party's identity.¹¹⁷ The trustee will be considered personally at fault, however, for allowing trust property to remain in dangerous condition, negligently hiring incompetent employees, and other negligent conduct.¹¹⁸ In the case of tort liability, however, there is no additional risk to

¹¹³ RESTATEMENT (SECOND) OF TRUSTS § 403. The trustee holds legal title to any trust property; thus any contracts he or she enters into are made personally on behalf of the trust. *Id.* § 261 (“The trustee is subject to personal liability to third persons on obligations incurred in the administration of the trust to the same extent that he would be liable if he held the property free of trust.”).

¹¹⁴ *Id.* § 403 cmt. a; *see also* G. Michael Richwine, *How Individual Trustees Can Avoid Liability and Breaches of Trust*, 24 EST. PLAN. 481, 482 (1997).

¹¹⁵ RESTATEMENT (SECOND) OF TRUSTS § 403 cmt. b. In the administration of a charitable trust, decisions may be made by majority vote of the trustees.

¹¹⁶ *Id.* §§ 188, 244.

¹¹⁷ *Id.* § 402(1) cmt. a. Trustee liability is not limited to beneficiaries of the trust; it also applies to strangers and employees.

¹¹⁸ *Id.*

trustees from forming as a charitable trust; generally, personal liability for governing members will attach only for intentional acts or omissions.¹¹⁹

In summary, where liability is an important issue given the nature of the organization's activities, the charitable trust may not be the form of choice because of the increased risk to trustees of personal liability from breach of fiduciary duties and breach of contract. However, a charitable trust may be appropriate for organizations, such as the After-school Program for Kids, that wish to impose a higher standard on the governing board because they have a strong interest in the proper supervision of any volunteers or employees and a strong interest in the proper investment of funds for future use.

B. Liability of Charitable Directors

Charitable directors owe fiduciary duties to the charitable corporation, and these duties may be enforced in a suit for breach of fiduciary duty.¹²⁰ A director who breaches his or her fiduciary duty will be held personally liable for any harm caused to the corporation.

¹¹⁹ *Id* § 402(1) cmt. b. Trustee of a charitable trust is not liable for the negligent actions of an employee if trustee exercised due care in hiring the employee.

¹²⁰ In addition to the attorney-general, most states grant members and fellow directors of charitable corporations standing to sue in a derivative capacity. Blasko, *supra* note 102, at 55; *see also* REV. MODEL NONPROFIT CORP. ACT § 6.30 (1987) (allowing proceedings to be brought by "(i) any member or members having five percent or more of the voting power or by fifty members, whichever is less; or, (ii) any director"). The RMNCA defines a member as "(without regard to what a person is called in the articles or bylaws) any person or persons who on more than one occasion, pursuant to a provision of a corporation's articles or bylaws, have the right to vote for the election of a director or directors." REV. MODEL NONPROFIT CORP. ACT § 1.40. Examples of state statutes granting members the right to sue for breach of fiduciary duties are New York, N.Y. NOT-FOR-PROFIT CORP. LAW § 623 (McKinney 2002); California, CAL. CORP. CODE §§ 5710, 7710 (West 2002); Georgia, GA. CODE ANN. § 14-3-741 (2002); Illinois, 805 ILL. COMP. STAT. 105/107.80 (2002); and Michigan, MICH. COMP. LAWS §§ 450.2491-.2493 (2002).

With respect to the duty of care, the business judgment rule, as described above, protects a director from personal liability for his business decisions.¹²¹ The rule provides a presumption that, when he made the business decision, the director was informed, acted in good faith, and believed the action was in the best interest of the charitable corporation; the party claiming breach of fiduciary duty has the burden of rebutting this presumption.¹²² To rebut the presumption, the claimant must show that the business judgment rule does not apply by introducing evidence of abuses by the director, such as fraud, self-dealing, bad faith, or abuse of discretion.¹²³ If sufficient evidence of abuse is introduced, the burden shifts to the directors to show that the business decision was fair and reasonable to the corporation.¹²⁴

With respect to the duty of loyalty, any claimant must show that the interested transaction was not approved by disinterested directors in the manner provided either by state statute or by the charitable corporation's organizational documents. If the procedures were not followed, the interested director, to avoid personal liability, must prove that the transaction was fair and reasonable to the corporation.¹²⁵

Directors of a charitable corporation may be held personally liable under contract and tort law; however, the corporate form limits such exposure. Generally, directors are

¹²¹ As described below, the charitable corporation may also limit liability for its directors by means of indemnification and insurance.

¹²² *E.g.*, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

¹²³ 1 KNEPPER & BAILEY, *supra* note 87, § 2-11, at 75.

¹²⁴ *Gorbow v. Perot*, 539 A.2d 180, 187 (Del. 1988).

¹²⁵ FISHMAN & SCHWARZ, *supra* note 54, at 214. Courts have found directors personally liable more often in cases alleging breach of the duty of loyalty than in duty-of-care cases. However, the penalties imposed for breaches of the duty of loyalty are often minimal, requiring simply repair of any harm to the corporation. *E.g.*, *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1019 (D.D.C. 1974) (penalizing the director-trustees of a charitable corporation for self-dealing by requiring them to read the court's opinion). *Contra* *John v. John*, 450 N.W.2d 795, 805-06 (Wis. Ct. App. 1990) (requiring director who engaged in self-dealing to pay restitution of \$1.17 million).

liable for a corporation's breach of contract only if they personally assume liability for the performance of the contract.¹²⁶ Similarly, directors are liable for tortious conduct only if the director independently committed a wrong against a third party, personally directed the tortious act, or meaningfully participated in the tortious act.¹²⁷ The RMNCA permits a charitable corporation to include a provision in its articles of incorporation that eliminates or limits directors' personal liability except in cases of breach of the duty of loyalty, self-dealing, acts or omissions in bad faith, intentional misconduct, and knowingly unlawful conduct.¹²⁸

Despite the director's limited liability under the corporate form, courts occasionally will apply the equitable doctrine of "piercing the corporate veil" to charitable corporations and impose personal liability on individuals who otherwise would be protected. The doctrine is derived from the for-profit sector and holds a director personally liable for the acts of the corporation if the director is so closely related to the corporation that they are

¹²⁶ *Godwin-Bever Co. v. G.P. Enter., Inc.*, 502 P.2d. 1124, 1126 (Colo. Ct. App. 1972); *see Dupack v. Nationwide Leisure Corp.*, 417 N.Y.S.2d 63, 65 (App. Div. 1979).

¹²⁷ *Frances T. v. Vill. Green Owners Ass'n*, 723 P.2d 573, 583-84 (Cal. 1986); *Burke v. Musarra*, 261 N.Y.S.2d 314, 315 (Sup. Ct. 1965). Some state statutes explicitly exempt directors from tort liability under certain conditions. *E.g.*, MASS. GEN. LAWS ch. 231, § 85W (2002) (exempting any director, officer, or trustee serving without compensation from any liability for civil damages relating to his or her performance as such, but excluding "acts or omissions intentionally designed to harm [and] grossly negligent acts or omissions which result in harm to the person"); ARK. CODE ANN. §§ 16-120-102 to -104 (Michie 2002) (stating that directors of charitable corporations are not personally liable for harms caused by negligent acts or omissions of other employees or board members, except for personal acts of ordinary or gross negligence and intentional torts committed by the director); N.Y. NOT-FOR-PROFIT CORP. LAW § 720-a (McKinney 2002) (exempting any director, officer, or trustee serving without compensation from liability to any person, but excluding "gross negligence or [action] intended to cause the resulting harm to the person asserting such liability"); GA. CODE ANN. § 51-1-20 (2002) (exempting members, directors, trustees (and officers serving without compensation) from civil liability if acting in good faith, but excluding "willful or wanton misconduct").

¹²⁸ REV. MODEL NONPROFIT CORP. ACT § 2.02(b)(5) (1987).

the “alter-ego” of each other.¹²⁹ In the for-profit sector, courts consider the degree of stock ownership as one determining factor, but because there are no stockholders in the charitable sector, there have been few cases in which courts have applied the doctrine to charitable corporations.¹³⁰ In those few cases, courts have looked to other factors that evidence control of the nonprofit entity, such as one individual making all management decisions, acting as the sole representative of the charitable corporation in transactions with third parties, or controlling the appointment of other officers.¹³¹ Piercing of the corporate veil is quite rare in the nonprofit sector.

In summary, the corporate form is advantageous to directors and officers because it limits personal liability for actions taken in their corporate capacity as long as they meet certain well-defined standards. These standards are specified in state statutes and may be outlined in organizational documents. Thus, directors are aware of their responsibilities and may be confident that if they meet the appropriate standards they will not be held personally liable for their acts on behalf of the charitable corporation. Potential directors must be aware of the conceivable exposure of liability and any available measures that may minimize that exposure before they agree to become governing members of the

¹²⁹ Courts apply a two-part test: (1) there must be unity of interest and ownership, and (2) there must be circumstances that make adhering to a separate corporate existence a fraud or a promotion of injustice. *E.g.*, *Gallagher v. Reconco Builders, Inc.*, 415 N.E.2d 560, 563-64 (Ill. App. Ct. 1980).

¹³⁰ Jane C. Schlicht, Comment, *Piercing the Nonprofit Corporate Veil*, 66 MARQ. L. REV. 134, 142-43 (1982). But

[t]he mere fact that the corporation involved is a nonprofit corporation does not by itself preclude a court from applying the equitable remedy of piercing the corporate veil. The equitable character of the remedy permits a court to look to the substance of the organization, and its decision is not controlled by the statutory framework under which the corporation was formed and operated.

1 WILLIAM MEADE FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 41.75, at 690 (rev. perm. ed. 1999) (footnote omitted).

¹³¹ *Macaluso v. Jenkins*, 420 N.E.2d 251, 255-56 (Ill. Ct. App. 1981); *Macfadden v. Macfadden*, 134 A.2d 531, 534-35 (N.J. Super. Ct. Ch. Div. 1957); *Ruppa v. Am. States Ins. Co.*, 284 N.W.2d 318, 324-25 (Wis. 1979). The entities in these cases were nonprofit corporations, but not charitable corporations.

organization, particularly in organizations that may be vulnerable to suit or criticism regarding operating methods, such as organizations that work in the healthcare field or with children.

C. Liability of Governing Members of Charitable Unincorporated Associations

As previously explained, there are no uniform fiduciary duties for charitable unincorporated associations, so it is difficult to address the liability of governing members for breach of those duties. With respect to breach of contract and tortious conduct, the liability of governing members of charitable unincorporated associations depends on whether the association is organized in a state that has implemented some or all of the provisions of the Uniform Act. Under the common law, members of an unincorporated association are liable both for the acts of other members, because members are considered co-principals, and for the organization's acts, because the organization is not a separate legal entity.¹³² Therefore, in a common-law state, a member of a charitable unincorporated association could be liable to third parties for breach of contract or the tortious conduct of others acting in the name of the organization, in addition to the member's own conduct.¹³³

The Uniform Act attempts to immunize governing members from vicarious liability for the association's and other members' breaches of contract and tortious activity.¹³⁴ The Uniform Act provides that a person is not liable for breach of the association's contract

¹³² Ian Davis, Note, *Membership has its Privileges: Court Sets Forth the Liability of Individual Members of Unincorporated Associations for Torts Against Third Parties: Juhl v. Airington*, 39 *Tex. Sup. Ct. J.* 830 (June 28, 1996), 28 *TEX. TECH L. REV.* 103, 105-07 (1997); Kenneth D. Lewis, Jr., Casenote & Comment, *The Ramifications of Idaho's New Uniform Unincorporated Nonprofit Associations Act*, 31 *IDAHO L. REV.* 297, 306-07 (1994).

¹³³ Davis, *supra* note 132, at 105-07; Lewis, *supra* note 132, at 306-09.

¹³⁴ UNIF. UNINCORPORATED NONPROFIT ASS'N ACT § 6 cmt. 9 (1996).

simply because of his or her status as a member or as part of the governing body.¹³⁵ It further provides that a person is not vicariously liable for the tortious conduct of the organization or other members.¹³⁶ However, as in the case of charitable corporations, members may still be held liable for their own tortious conduct, conduct they directed, or for contracts that they personally guaranteed.¹³⁷

For those considering formation in jurisdictions that have not adopted the Uniform Act, the possible imposition of vicarious liability may be the determining factor for rejecting the unincorporated association form. To explore yet another example, a small charitable entity, hypothetically called “Services for the Homeless,” that intends to provide goods and services to the poor and homeless such as food and clothing, may have a high risk of liability exposure because of the nature of its charitable activities. That organization may wish to incorporate or form a trust to protect its governing members from vicarious liability. In jurisdictions that have adopted the Uniform Act, the standards for fiduciary duties and for any corresponding liability remain unclear,¹³⁸ but the protections from vicarious liability should provide the same measure of security as that afforded charitable directors for contract and tort liability.

VII. Volunteer Liability

Organizations must also consider the potential personal liability of rank-and-file volunteers and governing members who serve without compensation. Concerns regarding the effect of personal liability for volunteers led to statutes in every state that affirmatively

¹³⁵ *Id.* § 6(b).

¹³⁶ *Id.* § 6(c), (d).

¹³⁷ *Id.* § 6 cmt. 2.

¹³⁸ *Supra* notes 95-97 and accompanying text.

limit the personal liability of at least some categories of volunteers.¹³⁹ In addition, on June 18, 1997, Congress passed the Federal Volunteer Protection Act of 1997 (the "Volunteer Protection Act")¹⁴⁰ to limit the liability of volunteers serving nonprofit organizations and thereby encourage the participation of volunteers on boards and in other capacities.¹⁴¹ This Section provides a general synopsis of statutory protections for volunteers.

Although a few state statutes only explicitly protect volunteers of a charitable corporation, most states do not premise immunity on the organization's choice of form.¹⁴² State volunteer protection statutes cannot completely immunize volunteers from liability, however, because state statutes cannot exempt volunteers from federal laws such as employment claims.¹⁴³ The lingering possibility of personal liability for volunteers despite state protections and the perceived need for more uniform protection of volunteers throughout the states led to the enactment of the Volunteer Protection Act, which was intended to clarify, standardize, and limit the liability risk assumed by charitable volunteers.¹⁴⁴

¹³⁹ E.g., ARK. CODE ANN. §§ 16-6-101 to -105 (Michie 2002); COLO. REV. STAT. § 13-21-116 (2002); 805 ILL. COMP. STAT. 105/108.70 (2002); MASS. GEN. LAWS ch. 231, § 85W (2002); N.Y. NOT-FOR-PROFIT CORP. LAW § 720-a (McKinney 2002); see also NONPROFITS' RISK MGMT. & INS. INST., NAT'L COUNCIL OF NONPROFIT ASS'NS, STATE LIABILITY LAWS FOR CHARITABLE ORGANIZATIONS AND VOLUNTEERS 1 (rev. ed. 1992); Charles Robert Tremper, *Compensation for Harm from Charitable Activity*, 76 CORNELL L. REV. 401, 402 (1991).

¹⁴⁰ Pub. L. No. 105-19, 111 Stat. 218 (codified at 42 U.S.C. §§ 14501-14505 (1997)).

¹⁴¹ Lisa A. Runquist & Judy F. Zybach, *Volunteer Protection Act of 1997 – Another Bad Law*, 17 EXEMPT ORG. TAX REV. 419, 419 (1997). Although the federal law defines volunteer to include only those governing members who serve without compensation, some state statutes protecting volunteers may also include compensated governing members. E.g., GA. CODE ANN. § 51-1-20 (2002).

¹⁴² Examples of state statutes that explicitly limit protection to volunteers of charitable corporations include Arizona, ARIZ. REV. STAT. § 12-982 (2002); California, CAL. CORP. CODE § 5239 (West 2002); and Michigan, MICH. COMP. LAWS § 450.2209(c)-(e) (2002). Because this issue is beyond the scope of this Article, the discussion will not distinguish among different forms. Organizations should check their local statute for guidance.

¹⁴³ See Daniel L. Kurtz, *Protecting Your Volunteer: The Efficacy of Volunteer Protection Statutes and Other Liability Limiting Devices*, C726 ALI-ABA 263, 289 (1992).

¹⁴⁴ See 42 U.S.C. § 14501. The Volunteer Protection Act provides that

There are five exceptions to the protection of immunity afforded by the Volunteer Protection Act: violent crimes, hate crimes, sexual offenses, violations of a state or federal civil rights law, and any misconduct while intoxicated.¹⁴⁵ Furthermore, a state volunteer statute may impose conditions on immunity.¹⁴⁶ The Volunteer Protection Act preempts any inconsistent state law unless the state statute provides additional protections for volunteers.¹⁴⁷ However, a state may elect to disregard the Act in any civil action in its courts if all of the parties to the action are citizens of the state.¹⁴⁸

In general, the Volunteer Protection Act protects volunteers from personal liability for torts against third parties.¹⁴⁹ However, the Act offers an affirmative defense; it does not prevent the commencement of lawsuits against volunteers.¹⁵⁰ A complainant need only allege that the harm was caused by the willful or criminal misconduct, gross negligence, or

no volunteer of a nonprofit organization . . . shall be liable for harm caused by an act or omission of the volunteer on behalf of the organization or entity if --

- (1) the volunteer was acting within the scope of the volunteer's responsibilities in the nonprofit organization . . . at the time of the act or omission;
- (2) if appropriate or required, the volunteer was properly licensed, certified, or authorized by the appropriate authorities for the activities or practice in the State in which the harm occurred, where the activities were or practice was undertaken within the scope of the volunteer's responsibilities in the nonprofit organization . . .;
- (3) the harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer; and
- (4) the harm was not caused by the volunteer operating a motor vehicle, vessel, aircraft, or other vehicle for which the State requires the operator or the owner of the vehicle, craft, or vessel to--
 - (A) possess an operator's license; or
 - (B) maintain insurance.

Id. § 14503(a).

¹⁴⁵ *Id.* § 14503(f).

¹⁴⁶ For example, a state may require mandatory training of volunteers or that the organization maintain insurance to compensate individuals harmed by the volunteer. *Id.* § 14503(d).

¹⁴⁷ *Id.* § 14502(a).

¹⁴⁸ *Id.* § 14502(b).

¹⁴⁹ *See id.* § 14503(b). The Act does not protect volunteers from lawsuits brought by the charitable organization. *Id.*

¹⁵⁰ Runquist & Zybach, *supra* note 141, at 419.

flagrant indifference of the volunteer in order to state a claim. Although the volunteer may ultimately succeed by invoking the Volunteer Protection Act as a defense, the threat of litigation discourages volunteers and forces charities to incur high insurance costs.¹⁵¹ Consequently, the Act may not be effective in achieving one of its stated goals: to prevent the withdrawal of volunteers from boards of directors and other charitable service.

Until there has been further interpretation of the Volunteer Protection Act's provisions, state law will influence choice of form with regard to concerns about volunteer liability. Organizations should consult the relevant state statutes, paying particular attention to the definition of volunteer, to ensure that the statute's protections cover all volunteers regardless of organizational form.

VIII. Insurance and Indemnification

As described above, charities can structure the personal liability of governing members through careful choice of form. However, even if members of a governing body conscientiously perform their duties, the governing members may still be subject to personal liability. Moreover, there are many situations where a governing member may be sued erroneously, subjecting the member to defense costs. To provide protection for the governing members, the organization may wish or even be required by law to indemnify governing members for these costs and liabilities incurred in their service to the organization.¹⁵² Indemnification therefore eliminates the fear of personal liability that discourages qualified candidates from serving as governing members of charitable organizations. Indemnification is false security for governing members, however, if the

¹⁵¹ See 42 U.S.C. § 14501(a)(6).

¹⁵² See Kurtz, *supra* note 75, at 470.

organization has little or no assets.¹⁵³ In that case, the organization may also purchase insurance—general liability or directors and officers (“D&O”) insurance or both—to reimburse the charitable organization for indemnification payments, to compensate injured third parties, or to reimburse directors and officers for liability payments not indemnified by the organization.¹⁵⁴ A charity may obtain D&O insurance for liability asserted against or incurred by its governing members regardless of whether it may indemnify them for that same liability.¹⁵⁵ D&O insurance policies generally consist of two parts: (1) reimbursement for the organization’s indemnification payments to governing members, and (2) payments for governing members when they are not entitled to indemnity.¹⁵⁶ Common exclusions from D&O insurance policies are fines, penalties, returned personal profits to which the governing member was not entitled, damages from intentional wrongdoing, and punitive damages.¹⁵⁷

The cost and availability of D&O insurance varies according to the organization’s activities and liability risk associated with those activities.¹⁵⁸ The form of the organization has little impact, if any, on the cost and availability of D&O insurance.¹⁵⁹ Organizations

¹⁵³ See John A. Edie, *Insurance and Indemnification: Basic Principles and Important Recent Changes*, C462 ALI-ABA 167, 178 (1989).

¹⁵⁴ See Kurtz, *supra* note 75, at 480. In this Section, the term “D&O insurance” refers to insurance for governing members of all forms, not only organizational forms with directors and officers.

¹⁵⁵ E.g., CAL. CORP. CODE § 5238(i) (Deering 2002); REV. MODEL NONPROFIT CORP. ACT § 8.57 (1987).

¹⁵⁶ JACQUELINE C. LEIFER & MICHAEL B. GLOMB, NAT’L CTR. FOR NONPROFIT BDS., *THE LEGAL OBLIGATIONS OF NONPROFIT BOARDS: A GUIDEBOOK FOR BOARD MEMBERS* 6 (2d ed. 1997); Michael C. Hone, *Indemnification and Officers and Directors Liability Insurance*, C726 ALI-ABA 55, 70 (1992).

¹⁵⁷ See Hone, *supra* note 156, at 71-73; Kurtz, *supra* note 75, at 481-82. Hone also notes that insurance for wrongful-termination claims may require higher deductibles because many claims result from wrongful termination.

¹⁵⁸ See Tremper, *supra* note 139, at 415-16. Tremper points to child-care providers as an example of organizations that may have difficulty obtaining insurance because some states permit child tort-victims to file suit up until their twenty-first birthday.

¹⁵⁹ An unincorporated association should be able to obtain insurance as long as they satisfy Section 501(c)(3). Nonprofit Coordinating Comm. of N.Y., *Directors and Officers Liability Insurance*, at

engaged in “risky” activities, such as After-school Program for Kids, should focus less on the accessibility of insurance than on the underlying liability issues that may impact choice of form. This Section addresses the indemnification process for each form.¹⁶⁰

A. Charitable Trust

The legal authority for indemnification of charitable trustees is unclear; no provision of the Restatement addresses indemnification of charitable trustees.¹⁶¹ Private trustees, however, are entitled to reimbursement from the trust for expenses properly incurred, including expenses attributable to defending trust assets where the litigation was not the fault of the trustee.¹⁶² By analogy, if a third party brought a suit against a charitable trustee who was not personally at fault,¹⁶³ the Restatement may provide a basis for reimbursement. The uncertainty of indemnification for charitable trustees, however, may make trusts less attractive for organizations with heightened risk of liability.¹⁶⁴

B. Charitable Corporation

State statutes generally govern indemnification for charitable directors and officers. A majority of states take an approach similar to the RMNCA.¹⁶⁵ The RMNCA has two provisions regarding indemnification. First, unless limited by the articles of incorporation,

<http://www.npcny.org/info/oi2.htm> (revised Oct. 2002). Theoretically, insurance for a charitable trustee should cost more than insurance for a corporate director because the trustee is held to higher fiduciary standards and therefore has a higher likelihood of liability. However, the cost of insurance depends more on the organization’s activities, perhaps because the charitable trustee, in reality, is often held to the same standard as the charitable director, either through a lower standard applied by a court or by language contained in the trust instrument.

¹⁶⁰ For further information regarding indemnification statutes, see Hone, *supra* note 156.

¹⁶¹ If an organization chooses to form a trust, the trust instrument should include indemnification obligations and standards to clarify the trust’s authority.

¹⁶² RESTATEMENT (SECOND) OF TRUSTS § 244 (1959); 3A SCOTT & FRATCHER, *supra* note 105, § 244, at 323-24.

¹⁶³ See *infra* note 177 and accompanying text.

¹⁶⁴ See Clark & Troost, *supra* note 86, at 34.

¹⁶⁵ See Kurtz, *supra* note 75, at 469.

a charitable corporation must indemnify a director for the reasonable expenses actually incurred by that director in the wholly successful, on the merits or otherwise, defense of any proceeding to which she is a party because of her role as a director.¹⁶⁶ The RMNCA requires the mandatory indemnification of officers to the same extent as directors, unless limited by the articles of incorporation.¹⁶⁷

Second, a charitable corporation may indemnify a director or officer for liability incurred in his official capacity if he (1) acted in good faith; (2) reasonably believed his conduct was in the best interests of the corporation; or (3) had no reason to believe that his conduct was unlawful.¹⁶⁸ However, a corporation may not indemnify a director or officer held liable in a suit brought by or on behalf of the corporation or a director or officer held to have obtained improper personal benefit in his official capacity.¹⁶⁹ The charter or bylaws usually describe this discretionary indemnification.¹⁷⁰

¹⁶⁶ See REV. MODEL NONPROFIT CORP. ACT § 8.52 (1987). The RMNCA does not limit mandatory indemnification to directors who are successful on the merits; therefore, the Act requires indemnification even if the director's defense is based on technical grounds such as statute of limitations. The mandatory indemnification provision applies to suits by the charitable corporation or its members, third-party claims, and suits brought by the Attorney-General. Some states, such as California, require that the director succeed on the merits before mandating indemnification. *E.g.*, CAL. CORP. CODE § 9246(d) (Deering 2002). However, California and other states offer more protection for directors than the RMNCA by requiring indemnification for directors who are partially successful in defending against suit. *Id.*; DEL. CODE ANN. tit. 8, § 145(c) (2002).

¹⁶⁷ REV. MODEL NONPROFIT CORP. ACT § 8.56.

¹⁶⁸ *Id.* §§ 8.51, 8.56.

¹⁶⁹ *Id.*

¹⁷⁰ See Kurtz, *supra* note 75, at 471. The RMNCA provides criteria for authorizing discretionary indemnification and for obtaining a court order to require the corporation to pay indemnification. REV. MODEL NONPROFIT CORP. ACT §§ 8.54, 8.55. Under the RMNCA, a charitable corporation may also advance expenses for litigation to a director or officer as long as certain conditions are met. The director or officer must provide the corporation with an affirmative statement that he or she has met the standard of conduct required for indemnification, he or she must enter into a written obligation to repay the organization if it is found that he or she did not meet that standard of conduct, and a determination must be made by those authorized to make such determination that the facts then known them do not preclude indemnification. *Id.* § 8.53.

States generally set clear guidelines for mandatory and discretionary indemnification for governing members of a charitable corporation. The certainty of this indemnification structure may make the corporate form more attractive for organizations, such as Services for the Homeless, which may be particularly vulnerable to claims because of the nature of the services they provide.

C. Charitable Unincorporated Association

The Uniform Act does not address indemnification; the principles of agency law determine to what extent a charitable unincorporated association may indemnify its governing members.¹⁷¹ If the association is a legal entity under state law, then it may be considered the principal on whose behalf the member, as agent, acts, and accordingly the member may be entitled to some form of indemnification from the association. The Restatement (Second) of Agency states that a principal has a duty to indemnify an agent to the extent that there is an indemnification agreement between the principal and the agent. Absent an agreement, the principal has a duty to indemnify the agent only where the agent makes a payment authorized by the principal and necessary in executing the principal's affairs, or where the agent suffers a loss that in fairness the principal should bear.¹⁷² The latter category may include, for example, reimbursement for expenses incurred in defense of claims brought by third parties for the member's acts on behalf of the association.

If the charitable unincorporated association is not a legal entity under state law, the legal authority for indemnification is unclear because it is unlikely that the principles of

¹⁷¹ Lizabeth A. Moody, *Nonprofit Organizations: Organizational Form and Structure* 17-18 (1989), at <http://www.law.nyu.edu/ncpl/library/publications/Conf1989MoodyPaper.pdf>.

¹⁷² RESTATEMENT (SECOND) OF AGENCY § 438 (1957).

agency apply. Because, as noted with respect to organizational liability, members are considered co-principals, they probably cannot be agents of each other or indemnify each other for the acts each has taken on behalf of the association.¹⁷³ Thus, an organization that wishes to indemnify its governing members should not form a charitable unincorporated association in a state that does not recognize those associations as legal entities.

IX. Organizational Liability

In addition to personal liability for managers or members, organizations must also consider the organization's liability for the acts of its agents. If state law recognizes an organization as a separate entity, the assets of that entity may be subject to liability for the acts of governing members or agents. By entering into contracts or engaging in tortious conduct, agents expose the organization to potential liability.

Historically, the common-law doctrine of charitable immunity shielded nonprofit organizations from tort liability.¹⁷⁴ In the 1940s and 1950s, however, states began to

¹⁷³ See *infra* notes 189-90 and accompanying text.

¹⁷⁴ *Developments, supra* note 75, at 1677-80; Note, *The Quality of Mercy: "Charitable Torts" and Their Continuing Immunity*, 100 HARV. L. REV. 1382, 1383-84 (1987). Relying on an English case that had been overruled, the Supreme Judicial Court of Massachusetts introduced the charitable immunity doctrine in the United States in 1876. *McDonald v. Mass. Gen. Hosp.*, 120 Mass. 432 (1876) (citing *Holliday v. St. Leonard's Parish*, 142 Eng. Rep. 769, 774 (C.P. 1861), *overruled by* *Foreman v. Canterbury Corp.*, 6 L.R.-Q.B. 214, 217-18 (Q.B. 1871)); see also Ronald M. Lipson, *Charitable Immunity: The Plague of Modern Tort Concepts*, 7 CLEV.-MARSHALL L. REV. 483, 484 (1958); Tremper, *supra* note 139, at 410. Despite the questionable precedent and subsequent disagreement over the justification for charitable immunity, see *Gable v. Salvation Army*, 100 P.2d 244, 245-48 (1940), most states accepted the doctrine during the early Twentieth Century, Bradley C. Canon & Dean Jaros, *The Impact of Changes in Judicial Doctrine: The Abrogation of Charitable Immunity*, 13 LAW & SOC'Y REV. 969, 971 (1979); Tremper, *supra* note 139, at 410. By 1938, forty states had adopted the charitable immunity doctrine. Canon & Jaros, at 971.

abolish the doctrine of charitable immunity.¹⁷⁵ By 1985, nearly every state—by statute or case law—had eliminated or significantly limited the doctrine.¹⁷⁶

States have differed in deciding where to strike the balance between limiting the liability of charitable organizations¹⁷⁷ and ensuring that victims are compensated and that charities are deterred from engaging in risky behavior. States continue to offer many protections to charitable organizations, and a trend toward granting charities a degree of immunity from suit has returned. Because the statutory immunity offered to charitable organizations varies from state to state,¹⁷⁸ organizations must carefully assess how choice

¹⁷⁵ *Developments, supra* note 75, at 1680 & nn.21-22 (describing the trend away from immunizing charitable organizations).

¹⁷⁶ *Id.* at 1680 & n.22; *see also* CHARLES ROBERT TREMPER, RECONSIDERING LEGAL LIABILITY AND INSURANCE FOR NONPROFIT ORGANIZATIONS app. D, at 187-201 (1989).

¹⁷⁷ Although some states protect a wider group of public-good organizations, this Article focuses on the protection afforded to Section 501(c)(3) organizations.

¹⁷⁸ *Developments, supra* note 75, at 1682-84. At least fifteen jurisdictions offer some form of protection to charitable organizations through statutes or case law.

In Arkansas, charities have full immunity. *See Williams v. Jefferson Hosp. Ass'n*, 442 S.W.2d 243, 244-45 (Ark. 1969); *Helton v. Sisters of Mercy of St. Joseph's Hosp.*, 351 S.W.2d 129, 131 (Ark. 1961). The New Jersey legislature and the Alabama and Virginia courts do not allow charities to be sued by the beneficiaries of their activities. N.J. STAT. ANN. § 2A:53A-7 (West 2002); *Autry v. Roebuck Park Baptist Church*, 229 So. 2d 469, 473-74 (Ala. 1969) (holding that a church is not liable to its members), *holding limited by Ex parte Wooten*, 681 So. 2d 149, 150 (Ala. 1996) (refusing to extend *Autry* to hospitals); *Radosevic v. Va. Intermont Coll.*, 633 F. Supp. 1084, 1086-87 (W.D. Va. 1986). In Wyoming, charitable organizations that provide free services retain full immunity. *Lutheran Hosps. & Homes Soc'y v. Yepsen*, 469 P.2d 409, 411-12 (Wyo. 1970). Maine grants full immunity to charitable organizations that are funded by charitable donations, *Thompson v. Mercy Hosp.*, 483 A.2d 706, 707 (Me. 1984), and Maryland grants full immunity to organizations that have their assets in trust and no liability insurance, *James v. Prince George's County*, 418 A.2d 1173, 1185 (Md. 1980). Both Maine and Maryland limit the liability of other charitable organizations to the amount of their liability insurance coverage. ME. REV. STAT. ANN. tit. 14, § 158 (West 2002); MD. CODE ANN., CTS. & JUD. PROC. § 5-406(c) (2002); *Eliason v. Funk*, 196 A.2d 887, 888 (Md. 1964); *Wood v. Abell*, 300 A.2d 665, 673 (Md. 1973). Georgia and Tennessee exempt the assets and property of charities from tort judgments. *Harrell v. Louis Smith Mem'l Hosp.*, 397 S.E.2d 746, 749-50 (Ga. Ct. App. 1990); *Hammond Post No. 3, Am. Legion v. Willis*, 165 S.W.2d 78, 80 (Tenn. 1942). In Colorado, trust funds are exempt from judgments, *Michard v. Myron Stratton Home*, 355 P.2d 1078, 1080-81 (Colo. 1960), and organizations that provide free services have immunity, COLO. REV. STAT. § 13-21-116 (2002); *Gilmore v. Concerned Parents of Pueblo*, 28 P.3d 963, 964-65 (Colo. Ct. App. 2000). Legislatures in Massachusetts, New Hampshire, South Carolina, and Texas have capped the amount of recovery that is allowed against certain charities. MASS. GEN. LAWS ch. 231, § 85K (2002); N.H. REV. STAT. ANN. § 508:17(II) (2002); S.C. CODE ANN. § 33-56-180 (Law. Co-op 2002); TEX. CIV. PRAC. & REM. CODE ANN. § 84.005 (Vernon 2002). In Utah, charities are protected from suits arising out of a volunteer's criminal activity. UTAH CODE ANN. §§ 78-19-1 to -3 (2002).

of form under state law affects organizational liability for the contracts and torts of its agents. However, there is a question of how often charitable organizations actually are sued, which question may limit the impact organizational liability should have on choice of form.¹⁷⁹

A. Charitable Trusts

Because at common law a trust is not a separate legal entity from the trustees, third parties seeking to recover damages for breach of contract or tort do not sue the charitable trust. Instead, the claimants name the trustees. As explained with regard to management liability, trustees are personally liable for tortious conduct where the trustee is personally at fault¹⁸⁰ and for contracts, unless the contract expressly provides that the trustee shall not be liable.¹⁸¹ If the trustee's assets are insufficient, then the claimant may seek to have the trust property applied in satisfaction of his or her claim.¹⁸²

Although claimants normally must exhaust the assets of the trustee before reaching trust property, there are circumstances where the trust may be liable for the full amount of any judgment. With respect to contracts, if the contract expressly provides that the trustee is not personally liable, the third party is entitled to reach the trust property in a proceeding in equity upon breach of contract by the trustee.¹⁸³ In addition, although it is

¹⁷⁹ Some commentators argue that public sentiment results in leniency toward nonprofit organizations. A few studies suggest support for this position; however, those studies surveyed a small number of organizations and had many non-responses. Tremper, *supra* note 139, at 412-14; David W. Barrett, Note, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L.J. 967, 970-74 (1996).

¹⁸⁰ RESTATEMENT (SECOND) OF TRUSTS § 402(1) (1959); *supra* notes 117-18 and accompanying text.

¹⁸¹ RESTATEMENT (SECOND) OF TRUSTS §§ 403, 262, 263; *supra* notes 113-16 and accompanying text.

Accordingly, contracts almost always expressly provide that the trustee shall not be held personally liable.

¹⁸² RESTATEMENT (SECOND) OF TRUSTS §§ 402(2), 403.

¹⁸³ *Id.* § 271.

unlikely that a contracting third party could maintain a legal suit directly against a charitable trust, the trust assets may be subject to full liability if the trust instrument provides that a trustee is entitled to reimbursement from the trust for any liability to third parties based on actions taken on behalf of the trust. With respect to torts, if no trustee is personally liable because none of the trustees are personally at fault for the tortious conduct, the claimant may attempt to sue the trust itself. It is questionable whether the tort victim can sue the charitable trust directly when none of the trustees are at fault.¹⁸⁴

Although the trust's immunity from suit may seem to be a positive feature, the corresponding personal liability for trustees may make it difficult for charitable trusts to attract qualified individuals to serve in governing positions. As explained with respect to management liability, however, an organization can modify the common-law rules by carefully drafting the trust instrument to provide indemnification to any trustee held liable in his or her capacity as a trustee. Accordingly, organizations must balance the need to protect the trust from potential liability against the trust's need for qualified trustees.

B. Charitable Corporations

In contrast, as a separate legal entity, a charitable corporation may be sued in its own name. The organizational liability of charitable corporations is based on agency law and the theory of respondeat superior.¹⁸⁵ Corporations are liable for the conduct of others if (i) there is an agency relationship; and (ii) the agent was acting within the scope of his or her employment.¹⁸⁶

¹⁸⁴ *Id.* § 402 cmt. b; 4A SCOTT & FRATCHER, *supra* note 105, § 402.2, at 659-60.

¹⁸⁵ Jeffrey D. Kahn, Comment, *Organizations' Liability for Torts of Volunteers*, 133 U. PA. L. REV. 1433, 1438 (1985).

¹⁸⁶ RESTATEMENT (SECOND) OF AGENCY § 219 (1957).

In the case of charitable organizations, the actor is often a volunteer. Although there is some debate as to whether volunteers for charitable organizations are agents for the purpose of applying the doctrine of respondeat superior, most courts have held that an agency relationship exists.¹⁸⁷ Furthermore, courts have held that an agent acts within the scope of his or her employment when others would perceive the agent as acting on behalf of the charitable corporation or when corporate authorities instruct the agent to perform such tasks.¹⁸⁸

C. Charitable Unincorporated Associations

The crucial factor in determining organizational liability for a charitable unincorporated association is whether it is considered an entity separate from its members and capable of being sued.¹⁸⁹ In common-law states, an unincorporated association is not a legal entity, and third parties with claims against the association must name the relevant governing members as defendants.¹⁹⁰ Thus, as explained with regard to management liability, directors and members of charitable unincorporated associations can be held personally liable for the actions of other members or volunteers of the association.¹⁹¹ Furthermore, because a charitable unincorporated association is not a legal entity under the common law, the imputed negligence doctrine bars a member of the association from

¹⁸⁷ *E.g.*, *Crossett Health Ctr. v. Croswell*, 256 S.W.2d 548, 550-51 (Ark. 1953); *Trinity Lutheran Church, Inc. v. Miller*, 451 N.E.2d 1099, 1102 (Ind. Ct. App. 1983). *But see* *Peden v. Furman Univ.*, 151 S.E. 907, 911 (S.C. 1930). The Restatement (Second) of Agency states that a volunteer may be an agent. RESTATEMENT (SECOND) OF AGENCY § 225 (“One who volunteers services without an agreement for or expectation of reward may be a servant of the one accepting such services.”).

¹⁸⁸ *E.g.*, *Baxter v. Morningside, Inc.*, 521 P.2d 946, 949 (Wash. Ct. App. 1974). For more information about imputing liability to a charitable corporation as a result of conduct by a volunteer, see Kahn, *supra* note 185, at 1438-43.

¹⁸⁹ See *supra* notes 11-29 and accompanying text.

¹⁹⁰ Wesley A. Sturges, *Unincorporated Associations as Parties to Actions*, 33 YALE L.J. 383, 383 (1924).

¹⁹¹ *Supra* notes 132-33 and accompanying text.

suing the organization for tortious activity.¹⁹² Because each member is a co-principal of the association, any suit by a member is considered a suit against himself.¹⁹³

Although many common-law jurisdictions continue to hold that charitable unincorporated associations cannot sue or be sued by third parties or members,¹⁹⁴ some state courts have allowed unincorporated associations to be sued by third parties, and even members.¹⁹⁵ Therefore, it is possible that, in those states that have not adopted the Uniform Act, courts will allow the unincorporated association to be sued by either third parties or members of the association. To ensure that the entity can be sued and that members, directors, and officers will not be subject to personal liability, however, organizations in common-law states may wish to form charitable corporations.

In contrast to the common law, section 6 of the Uniform Act states that “[a] nonprofit association is a legal entity separate from its members for the purposes of determining and enforcing rights, duties, and liabilities in contract and tort.”¹⁹⁶ By conferring legal status on associations,¹⁹⁷ the Uniform Act places the charitable

¹⁹² Davis, *supra* note 132, at 106-07; *see also* Lewis, *supra* note 132, at 307.

¹⁹³ *Id.*

¹⁹⁴ *See* Cullen, *supra* note 14, at 45; Lewis, *supra* note 132, at 307.

¹⁹⁵ *White v. Cox*, 95 Cal. Rptr. 259, 261 (Ct. App. 1971) (“[W]e conclude that unincorporated associations are now entitled to general recognition as separate legal entities and that as a consequence a member of an unincorporated association may maintain a tort action against his association.”); *Crocker v. Barr*, 409 S.E.2d 368, 372 (S.C. 1991) (“We hold that . . . an unincorporated association, regardless of its underlying purpose, is amendable to suit by its members for tortious acts.”); *Cox v. Thee Evergreen Church*, 836 S.W.2d 167, 173 (Tex. 1992) (addressing association liability before the passage of the Texas Uniform Unincorporated Nonprofit Association Act, TEX. REV. CIV. STAT. ANN. art. 1396-70.01 (Vernon 2002)) (“We allow suits by and against unincorporated associations in their own name. We allow nonmembers to bring suits, including those for negligence, against unincorporated associations. We allow members to sue unincorporated associations for acts committed that are strictly adverse to the member’s interests. . . . [A] member of an unincorporated charitable association is not precluded from bringing a negligence action against the association solely because of the individual’s membership in the association.” (citations omitted)).

¹⁹⁶ UNIF. UNINCORPORATED NONPROFIT ASS’N ACT § 6(a) (1996).

¹⁹⁷ The Uniform Act also conversely grants a nonprofit association the right to assert a claim in its own name or on behalf of its members: if (1) one or more members of the nonprofit association have standing to assert a claim in their own right; (2) the interests that the nonprofit association seeks to protect are germane to its

unincorporated association on par with the charitable corporation.¹⁹⁸ Accordingly, organizational liability is based on respondeat superior, and an organization may be liable for the actionable conduct of its agents.¹⁹⁹ Therefore, in the states that have adopted the Uniform Act, concerns about organizational liability should not influence choice of form between the corporation and the unincorporated association.

X. Modifications

Throughout the life of a charity, governing members may, from time to time, wish to alter the administrative and procedural provisions of the organizational documents in order to better enforce the charity's purpose. In extreme cases, governing members may even seek to alter the purpose of the organization where, as the result of changed circumstances, the original charitable purpose becomes impossible, impracticable, or has already been accomplished.²⁰⁰ The ability of governing members to modify organizational documents varies among the three charitable forms.

A. Charitable Trusts

Two doctrines apply to changes sought by charitable trustees. The administrative deviation doctrine applies when the trustee seeks to alter the administrative or procedural terms of the trust, but not the original charitable purpose.²⁰¹ The doctrine of cy pres

purposes; and (3) neither the claim asserted nor the relief requested requires the participation of a member. *Id.* § 7(a), (b).

¹⁹⁸ The prefatory note to the Idaho Uniform Unincorporated Nonprofit Association Act states that the Act is “needed for the informal nonprofit organizations that do not have legal advice and so may not consider whether to incorporate.” IDAHO CODE § 53-701, prefatory note (Michie 2002).

¹⁹⁹ *Supra* notes 185-188 and accompanying text.

²⁰⁰ FISHMAN & SCHWARZ, *supra* note 54, at 106-08. If a charitable organization substantially alters its purpose, tax-exempt status can be affected. Organizations must be careful to ensure that their 501(c)(3) status will not be affected by any change of purpose.

²⁰¹ Chris Abbinante, Comment, *Protecting “Donor Intent” in Charitable Foundations: Wayward Trusteeship and the Barnes Foundation*, 145 U. PA. L. REV. 665, 683 (1997).

applies when it becomes impossible or impracticable for the trustee to follow the trust's original charitable purpose and the trustee seeks to modify the trust to follow the trust's general charitable objective as closely as possible.²⁰² The distinction between administrative deviation and cy pres is not always clear. It is often difficult to determine whether a particular issue relates to the administration or the purpose of the trust because administrative and procedural restrictions are so closely intertwined with charitable purpose.²⁰³ Therefore, although this Article discusses the doctrines separately, organizations should be aware that charitable trustees may be able to justify the application of whichever doctrine is most likely to accommodate the desired changes.

1. Changing Administrative Procedures and Trustees

Under the doctrine of administrative deviation, a court may modify, upon petition by the charitable trustee, requirements imposed on the charitable trust to ensure compliance with the original purpose, when compliance with the requirements is impossible or illegal or would greatly impair the general intent of the trust.²⁰⁴ Some courts require near impossible conditions before applying the deviation doctrine, while most courts permit deviation when compliance with the trust requirements is still possible, but it is inefficient and cumbersome.²⁰⁵ Using the deviation doctrine, courts have authorized an

²⁰² Domenic P. Aiello & Tracy Adler Craig, *Cy Pres: Reformation of the Charitable Trust*, 81 MASS. L. REV. 110, 110 (1996); Abbinante, *supra* note 201, at 680-81.

²⁰³ Abbinante, *supra* note 201, at 685-86; Roger G. Sisson, Comment, *Relaxing the Dead Hand's Grip: Charitable Efficiency and the Doctrine of Cy Pres*, 74 VA. L. REV. 635, 645 (1988).

²⁰⁴ RESTATEMENT (SECOND) OF TRUSTS § 381 (1959) ("The court will direct or permit the trustee of a charitable trust to deviate from a term of the trust if it appears to the court that compliance is impossible or illegal, or that owing to circumstances not known to the settlor and not anticipated by him compliance would defeat or substantially impair the accomplishment of the purposes of the trust.").

²⁰⁵ *E.g.*, *Trustees of Dartmouth Coll. v. City of Quincy*, 258 N.E.2d 745, 751, 753 (Mass. 1970) (applying the deviation doctrine to alter the testator's will, which had established a school for the education of females born in the town of Quincy, because changed circumstances made the testator's conditions obstructive and inappropriate to the primary charitable object, even though compliance was not impossible); *City of*

increase in the number of trustees;²⁰⁶ the sale or mortgaging of property, despite a restriction on sales or mortgages in the trust instrument;²⁰⁷ the transfer of property to a new trustee;²⁰⁸ and the elimination of racial or religious restrictions.²⁰⁹ The deviation standards may burden trustees faced with changing circumstances in the governance of a trust.

Another burden on trust governance is that trusts may have difficulty changing trustees. A trustee may need court approval before resigning from her position and selecting a successor.²¹⁰ Governing members with the authority to resign can appoint successors who are better equipped to deal with changed circumstances and who can introduce new methods for achieving the charitable purpose.

Although it appears that the charitable trustee has little flexibility to make changes, this inflexibility may be eliminated by carefully drafting the trust instrument. The trust instrument can grant the trustee the authority to resign, appoint successors, and amend the trust instrument without court approval, thus reducing the real-world impact on choice of form of these potential burdens on trustees.²¹¹

Worcester v. Dirs. of Worcester Free Public Library, 211 N.E.2d 356, 359 (Mass. 1965) (requiring either impossibility or impracticability, but refusing to apply the deviation doctrine because the court determined it was not impracticable to comply with the trust instrument); *see also* EDITH L. FISCH ET AL., CHARITIES AND CHARITABLE FOUNDATIONS § 547, at 407 (1974); Comm. on Charitable Trusts & Founds., *Cy Pres and Deviation: Current Trends in Application*, 8 REAL PROP. PROB. & TR. J. 391, 401-02 (1973) [hereinafter *Cy Pres*].

²⁰⁶ *E.g.*, Reagh v. Hamilton, 78 P.2d 555, 558 (Wash. 1938).

²⁰⁷ *E.g.*, Bond v. Town of Tarboro, 7 S.E.2d 617, 619-20 (N.C. 1940); Grace Church v. Ange, 77 S.E. 239, 240-41 (N.C. 1913).

²⁰⁸ *E.g.*, Gordon v. City of Baltimore, 267 A.2d 98, 109-11 (Md. 1970).

²⁰⁹ *E.g.*, Bank of Del. v. Buckson, 255 A.2d 710, 717 (Del. Ch. 1969); Coffee v. William March Rice Univ., 408 S.W.2d 269, 285-87 (Tex. Civ. App. 1966)

²¹⁰ Clark & Troost, *supra* note 86, at 33.

²¹¹ *Id.*; *see also* FISHMAN & SCHWARZ, *supra* note 54, at 70 n.13.

2. Changing Charitable Purpose

Recognized in almost all states, cy pres is an equitable doctrine applied by courts to permit a trustee to change the trust's charitable purpose when its mission becomes impossible, impracticable, or illegal.²¹² Before a court applies cy pres, the trustee must show (1) that the donor transferred property in trust for a particular charitable purpose; (2) that it is impossible, impracticable, or illegal to carry out the particular charitable purpose; and (3) that the donor manifested a general charitable intention, which is not limited to the frustrated specific purpose.²¹³ In applying cy pres, the court must follow the original purpose as nearly as possible when modifying the charitable purpose.²¹⁴

The cy pres doctrine greatly hinders the trustee's ability to use the trust's charitable assets for a different charitable purpose when the original charitable purpose becomes difficult to achieve. If a trustee uses any trust property for a different charitable purpose without court authorization, the trustee may be subject to liability for breach of trust.²¹⁵

Before applying the doctrine, a court must determine that there is a high degree of

²¹² RESTATEMENT (SECOND) OF TRUSTS § 399 (1959) (“If property is given in trust to be applied to a particular charitable purpose, and it is or becomes impossible or impracticable or illegal to carry out the particular purpose, and if the settlor manifested a more general intention to devote the property to charitable purposes, the trust will not fail but the court will direct the application of the property to some charitable purpose which falls within the general charitable intention of the settlor.”); FISHMAN & SCHWARZ, *supra* note 54, at 116.

²¹³ EDITH L. FISCH, *THE CY PRES DOCTRINE IN THE UNITED STATES*, § 5.00, at 128 (1950); Alex M. Johnson, Jr. & Ross D. Taylor, *Revolutionizing Judicial Interpretation of Charitable Trusts: Applying Relational Contracts and Dynamic Interpretation to Cy Pres and America's Cup Litigation*, 74 IOWA L. REV. 545, 561-62 (1989); *Cy Pres*, *supra* note 205, at 391. It is usually difficult to identify a general charitable intent because the trust instrument rarely has instructions for how to apply the charitable assets if the trust fails. However, courts have found a general charitable intent despite clear evidence to the contrary, such as provisions instructing that the property be devoted to the specific charitable purpose “forever” or devoted to that purpose “and no other purpose.” RESTATEMENT (SECOND) OF TRUSTS § 399 cmt. c; FISCH, *supra* note 205, § 575, at 438-42.

²¹⁴ Abbinante, *supra* note 201, at 680.

²¹⁵ RESTATEMENT (SECOND) OF TRUSTS § 399 cmt. e. The court may approve the trustee's use of trust property and protect the trustee from liability for breach of trust, if the court would have directed a similar use of the assets under the cy pres doctrine. *Id.*

frustration of the original charitable purpose, that the donor implicitly consented to a change in purpose consistent with her general charitable intent, and that the new charitable purpose is not significantly different.²¹⁶

In light of the limitations imposed by the cy pres doctrine, founders that anticipate the need to change an organization's charitable purpose, such as Save the Wetlands, which recognizes that its purpose is accomplished once it purchases and saves the particular wetland, may not wish to form as a trust. However, founders can avoid some difficulties of the cy pres doctrine by drafting the trust instrument provisions regarding disposition or alternative use of charitable assets when the trust's original charitable purpose becomes impossible or inefficient to fulfill. These provisions would provide the trustee with more flexibility to address changed circumstances. Additionally, trustees could take calculated risks by using trust assets for a different charitable purpose without court approval, when the trustee thinks that the court would approve the change if the trustee made the proper application.²¹⁷ Therefore, as with many other factors analyzed throughout the Article, theoretical problems with respect to the trust's ability to change organizational procedures or charitable purpose may be mitigated in practice by carefully drafting the trust instrument.

²¹⁶ FISHMAN & SCHWARZ, *supra* note 54, at 106. Unlike the administrative deviation doctrine, courts have been reluctant to apply cy pres when use of the property for the original charitable purpose has become simply inefficient. *E.g.*, *Town of Boscaawen v. Acting Attorney Gen.*, 43 A.2d 780, 781 (N.H. 1945); *In re Thorne's Will*, 102 N.Y.S.2d 386, 388-90 (Sur. Ct. 1951); *see also In re Estate of Buck*, No. 23259 (Cal. Super. Ct. Aug. 15, 1986), *reprinted in* 21 U.S.F. L. REV. 691, 720 (1987). Moreover, organizations should be aware that the Attorney-General or any other person with an interest under the trust may make an application under the doctrine of cy pres. RESTATEMENT (SECOND) OF TRUSTS § 399 cmt. f. The court could then apply cy pres and frame another charitable purpose for the trust without the trustee's consent. *Id.*

²¹⁷ FISCH, *supra* note 205, § 586, at 461-62. Trustees probably engage in this activity, despite the risk of liability for breach of trust, because a court can subsequently approve the transactions. *Supra* note 215.

B. Charitable Corporations

Directors generally have a great deal of flexibility in the internal governance of the charitable corporation. While the articles of incorporation set out the organization's charitable purpose, the bylaws detail the corporation's administrative procedures, and it is often less complicated to amend the corporate bylaws than the articles of incorporation.

1. Changing Administrative Procedures and Directors

Most state statutes authorize a charitable corporation to amend its articles of incorporation.²¹⁸ However, procedures for amending the articles of incorporation and the bylaws typically are laid out in the articles, and those procedures can give directors more or less flexibility to modify the organizational documents than provided by state law.²¹⁹ Modifications may include changing the number of directors or officers or changing the responsibilities and rights of directors or officers to grant the governing members greater ability to carry out the charitable purpose.

The amendment procedures are quite simple. The RMNCA requires that, unless the articles of incorporation provide otherwise,²²⁰ all directors must be notified of any meeting at which the board will vote on an amendment, and the amendment must be approved by a majority of directors.²²¹ Most states further require that the charitable corporation file articles of amendment with the proper state agencies.²²²

²¹⁸ *E.g.*, ALA. CODE § 10-3A-80 (2002); ALASKA STAT. § 10.20.171 (Michie 2002); ARIZ. REV. STAT. § 10-11001 (2002).

²¹⁹ FISHMAN & SCHWARZ, *supra* note 54, at 72-73.

²²⁰ For example, the articles of incorporation may require that a third party, other than the board, approve in writing any amendments to the articles or bylaws. *E.g.*, REV. MODEL NONPROFIT CORP. ACT § 10.30 (1987).

²²¹ *Id.* §§ 10.02(b), 10.20.

²²² *E.g.*, ARIZ. REV. STAT. § 10-11006 (2002); COLO. REV. STAT. § 7-130-105 (2002); MASS GEN. LAWS ch. 180, § 7 (2002).

The election of new directors or officers also serves as a vehicle for change because new governing members can create different approaches for fulfilling the charitable purpose, rather than amending the organizational documents.²²³ A charitable corporation may hold elections following the resignation or death of a director or officer.

2. Changing Charitable Purpose

Through legislation or common law, some states mandate that directors do not have the authority to amend the articles of incorporation if the amendments change the corporation's charitable purpose.²²⁴ In those jurisdictions, modifications that seek to effect a change in charitable purpose may be subject to the doctrine of quasi cy pres. Under quasi cy pres, courts apply similar criteria to charitable corporations as is applied to charitable trusts under the cy pres doctrine. The attorney-general and a court must review the proposed modification. As with the cy pres doctrine, the court ensures that the change preserves the general charitable intent of the founders and donors.²²⁵

Furthermore, the doctrine of cy pres may be applied to charitable corporations if desired changes affect certain donated assets. Many states view a charitable corporation as holding donated property in trust, and therefore those states apply trust doctrines to the charitable corporation with respect to the donated property.²²⁶ As a consequence, the

²²³ Clark & Troost, *supra* note 86, at 33.

²²⁴ *E.g.*, *Alco Gravure, Inc. v. Knapp Found.*, 479 N.E.2d 752, 753 (N.Y. 1985) (holding that the power to amend the articles of incorporation is limited if the amendment would change the purpose for which the funds were given to the charitable corporation); *see also* N.Y. NOT-FOR-PROFIT CORP. LAW § 804 (McKinney 2002) (requiring a charitable corporation to obtain state supreme court approval, after notice to the Attorney-General, before it may amend its purposes or powers); *Attorney Gen. v. Hahnemann Hosp.*, 494 N.E.2d 1011, 1021 (Mass. 1986) (explaining in dicta that directors must satisfy the equitable doctrines of cy pres or deviation for any amendment to the articles of organization that would authorize the use of charitable assets for a new purpose).

²²⁵ *See supra* notes 212-16 and accompanying text.

²²⁶ FISHMAN & SCHWARZ, *supra* note 54, at 120-21; 4A SCOTT & FRATCHER, *supra* note 105, § 348.1, at 23-24; *see also* RESTATEMENT (SECOND) OF TRUSTS § 399 cmt. a. (stating that the doctrine of cy pres is “peculiar

directors and officers of the charitable corporation have the additional fiduciary responsibilities of a trustee with respect to the property. The governing members are held to the earmarked purposes, restrictions, or covenants placed on the use of any gifted property, unless a court authorizes them to substitute another purpose or to abolish the restrictions because of changed circumstances.²²⁷

In summary, the charitable corporate form may be attractive because of the ease with which governing members may accomplish administrative and procedural changes. For example, Save the Wetlands may want to incorporate because it can foresee changed circumstances, such as the sale of the wetlands to either the organization or another party, that might necessitate structural changes. The organization should be careful, however, to broadly define its environmental purpose in its articles of incorporation, or it runs the risk of needing court approval for any changes in purpose. Although a court would likely approve a change of charitable purpose because the original purpose would either have been accomplished or made impossible after the sale of the wetlands, administrative changes could be made more expediently and without concerns about the application of cy pres.

to charitable trusts *and charitable corporations*" (emphasis added)). States vary with regard to whether the donor of property must place restrictions on its use or earmark it for a specific purpose in order for the charitable corporation to be considered a trustee of the donated property. For examples of states where a charitable corporation is not a trustee of property if the property is donated without restriction, see N.Y. NOT-FOR-PROFIT CORP. LAW § 513 (McKinney 2002); *Y.W.C.A. v. Morgan*, 189 S.E.2d 169, 172 (N.C. 1972); *Alumnae Ass'n of Newport Hosp. Sch. of Nursing v. DeSimone*, 258 A.2d 80, 82 (R.I. 1969); *cf. Palmer v. Evans*, 124 N.W.2d 856, 863-64 (Iowa 1963) (explaining in dicta that the cy pres doctrine applies when a testator leaves property to a corporation for certain charitable purposes). Other states, such as California, have held that a charitable corporation holds donated assets in trust, whether or not such assets were donated with restrictions, for the purposes outlined in the corporation's articles of incorporation. *E.g., Lynch v. Spilman*, 431 P.2d 636, 642 (Cal. 1967).

²²⁷ *E.g., St. Joseph's Hosp. v. Bennet*, 22 N.E.2d 305, 308 (N.Y. 1939) (holding that a charitable corporation that receives a gift for a specific purpose may not use the gift for another purpose without a court authorizing the change through the cy pres doctrine).

C. Charitable Unincorporated Associations

1. Common Law States

In states that have not adopted the Uniform Act, charitable unincorporated associations must have an organizational document, which may describe the organization's charitable purpose, procedures for electing officers, and other administrative details.²²⁸

Governing members have a great deal of flexibility because courts generally do not interfere with the internal management of charitable unincorporated associations.²²⁹

Amendments to the articles of association may be made by whatever procedure is described in the articles or by general agreement of the members if the articles do not contain procedures for amendment.²³⁰

For a charitable unincorporated association under the common law, the association's members generally are held to be the owners of the association's property, because without separate legal status, the association itself cannot own property.²³¹ Thus, the doctrine of cy pres would not apply because charitable unincorporated associations cannot legally receive property in trust.²³²

²²⁸ Although an association can legally exist without articles of association or bylaws, it cannot qualify for 501(c)(3) status without an organizational document. FISHMAN & SCHWARZ, *supra* note 54, at ; *cf.* FISCH, *supra* note 205, § 244, at 226 (describing the creation of unincorporated associations).

²²⁹ OLECK & STEWART, *supra* note 30, § 57, at 157.

²³⁰ *See id.* § 59, at 159.

²³¹ *Infra* notes 2631-65 and accompanying text.

²³² RESTATEMENT (SECOND) OF TRUSTS § 399 cmt. a (1959) (stating that cy pres is peculiar to charitable trusts and corporations). Cy pres can apply, however, to specific devised or bequeathed property that the charitable unincorporated association cannot legally receive. If the testator manifested an intent to devote the property to general charitable purposes, and not necessarily the specific association, the court may permit the gift to go to another charity. *Id.* § 399 cmt. o.

2. Uniform Act States

Even in states that have adopted the Uniform Act, there is no default rule regarding the procedures for electing officers and modifying organizational documents with respect to charitable unincorporated associations.²³³ Founders of charitable unincorporated associations should include these procedures in the articles of association or other organizational documents.

Cy pres, however, may apply to charitable unincorporated associations that are recognized as separate legal entities. As a legal entity, an association has the right to hold property; therefore, state courts that have recognized a charitable corporation as holding donated property in trust should recognize the charitable unincorporated association as holding property in trust.²³⁴

Because very few state statutes address the internal governance of a charitable unincorporated association, this form might be attractive to organizations that wish to provide their governing members with a great deal of flexibility. If necessary, founders can restrict the actions of governing members through the articles of association. Services for the Homeless, for example, may anticipate growth from a local service to a large regional or national organization, employing volunteers initially, but hiring permanent staff as it expands. Accordingly, the founders of the organization may prefer the association form over the trust form because the organization's circumstances may change greatly. Organizations should note, however, that the organizational documents for corporations and trusts could provide governing members with similar flexibility to easily

²³³ *Supra* note 96 and accompanying text.

²³⁴ *See supra* note 226 and accompanying text.

make administrative and organizational changes, while still placing desired restraints on their actions.

XI. Dissolution

The dissolution process varies among organizational forms and, thus, may influence an organization's choice of form. In broad terms, the voluntary dissolution of a charitable trust requires prior approval from a court or the attorney-general, absent a different procedure in the trust instrument. The voluntary dissolution of a charitable corporation must comply with statutory requirements and usually requires pre-approval by a governmental entity. There are no clear statutory or common-law requirements governing the dissolution of charitable unincorporated associations. The dissolution procedures for charitable corporations and charitable trusts can be lengthy and complicated because they require government approval.

A. Charitable Trust

The doctrine of cy pres, as discussed with regard to modifications, governs the dissolution of charitable trusts.²³⁵ Where fulfillment of a charitable trust's purpose becomes impossible, impracticable, or illegal, a trust may ask a court to dissolve the trust.²³⁶ This process can be time consuming, and founders should carefully consider the issue when forming an organization.

²³⁵ See *supra* notes 212-16 and accompanying text.

²³⁶ E.g., *Davison v. Deslauriers*, 288 A.2d 250, 253-55 (R.I. 1972).

B. Charitable Corporations

Specific requirements for dissolution of charitable corporations vary widely from state to state. Accordingly, before dissolution of a charitable corporation, organizations should consult the state statute governing dissolution.²³⁷ This Section only focuses on the dissolution requirements of the RMNCA.

Charitable corporations begin the dissolution process by adopting a plan of dissolution that names the parties to whom the corporation's assets will be distributed upon dissolution.²³⁸ Depending on the charitable corporation's voting structure, the plan of dissolution may be adopted by a vote of the corporation's members or, if there are no voting members, by the board of directors.²³⁹ After the plan of dissolution has been adopted, the corporation's liabilities have been discharged, and all property has been distributed, articles of dissolution must be delivered to the secretary of state.²⁴⁰ The corporation may legally dissolve after the secretary of state approves the articles of

²³⁷ Only the state of incorporation has the authority to dissolve a corporation. RESTATEMENT OF CONFLICT OF LAWS § 157 (1934); *see, e.g.*, CAL. CORP. CODE §§ 5132(a)(2)(i), 6610, 7132(a)(4)(i) (Deering 2002) (providing that a nonprofit corporation may voluntarily dissolve if the corporation (a) has been adjudicated bankrupt; (b) has disposed of all of its assets and has not conducted any activity in the immediate five years preceding the resolution to dissolve; (c) has no members; or (d) was a subordinate entity of a head organization that revoked the subordinate's charter); FLA. STAT. chs. 617.1401, 617.1403 (2002) (requiring that a nonprofit corporation file a resolution to dissolve with the Department of State); N.Y. NOT-FOR-PROFIT CORP. LAW § 1002(d) (McKinney 2002) (providing that the corporation's dissolution plan must be approved by a justice of the supreme court in the jurisdiction where the office of the corporation is located); OHIO REV. CODE ANN. § 1702.48 (Anderson 2002) (requiring public notice of dissolution by publication in a newspaper of general circulation in the county where the corporation's principal office is located and by mail or personal service on all creditors of and claimants against the dissolved corporation).

²³⁸ REV. MODEL NONPROFIT CORP. ACT §§ 14.01, 14.02 (1987); *see also, e.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW § 1002(a); OHIO REV. CODE ANN. § 1702.47.

²³⁹ REV. MODEL NONPROFIT CORP. ACT §§ 14.01, 14.02.

²⁴⁰ *See id.* § 14.04 (setting forth provisions that should be included in the articles of dissolution). Again, organizations should consult applicable state statutes to determine appropriate filing requirements. *E.g.*, CAL. CORP. CODE § 6615 (requiring that before a corporation files a certificate of dissolution, it must file a certificate of satisfaction from the Franchise Tax Board that all taxes imposed under the Bank and Corporation Tax Law have been paid or secured).

dissolution.²⁴¹ In addition, the corporation must notify the attorney-general of its intention to dissolve.²⁴² The attorney-general can consent to or take no action on the proposed dissolution or oppose the dissolution if it is not in the public interest.²⁴³ After approving the articles of dissolution, the secretary of state issues a certificate of dissolution, and the charitable corporation ceases to exist.²⁴⁴

C. Charitable Unincorporated Association

Under the common law and the Uniform Act the procedure for dissolving a charitable unincorporated association is unclear. At least one commentator has speculated that because a charitable unincorporated association may be formed by the agreement of its members, it may likewise be dissolved on agreement of its members in compliance with its organizational document.²⁴⁵ However, for the organization to obtain tax-exempt status under Section 501(c)(3), its organizational documents must specify how the association's assets would be distributed for an exempt purpose on dissolution. Therefore, because the

²⁴¹ REV. MODEL NONPROFIT CORP. ACT § 14.04(a).

²⁴² *Id.* § 14.03(a) (requiring written notice to the attorney general of a corporation's intention to dissolve, at or before the time the corporation delivers the articles of dissolution to the secretary of state); *see also* CAL. CORP. CODE § 6611(a) (requiring written notice to attorney general of election to dissolve corporation); N.Y. NOT-FOR-PROFIT CORP. LAW § 1003(a), (b) (requiring written notice to the attorney general of intention to dissolve, proof of which must be submitted to the court before approval of the dissolution).

²⁴³ *See* REV. MODEL NONPROFIT CORP. ACT § 14.03.

²⁴⁴ After dissolution, the directors, officers, and members of a dissolved corporation typically are allowed to continue functioning for the purpose of concluding the corporation's affairs. *Id.* § 14.06(a) (providing for continued corporate existence after dissolution solely to wind up corporate affairs); *see also* CAL. CORP. CODE § 6720; N.Y. NOT-FOR-PROFIT CORP. LAW §§ 1005, 1006. Many statutes establish a three-year (or "reasonable") time period after dissolution within which the winding-up process must be overseen and completed. *E.g.*, DEL. CODE ANN. tit. 8, § 278 (1998); OHIO REV. CODE ANN. § 1702.49(D) (Anderson 2002). However, in other states, the winding-up process must precede the corporate dissolution. *E.g.*, MINN. STAT. § 302A.711(2)(a)(5) (2002); WASH. REV. CODE § 24.03.240 (2002).

²⁴⁵ Moody, *supra* note 171, at 13 n.49 ("It is likely that principles of agency law allowing for the revocation of consent to the relationship would govern.").

organizational document would likely govern dissolution, an organization should include dissolution procedures in its organizational document.

If a charitable unincorporated association's members determine the dissolution process, the dissolution of charitable associations could be achieved with relative ease. Thus, organizations such as Save the Wetlands, which knows that its purpose will either be quickly accomplished or unnecessary if they cannot purchase the wetland, may wish to form as unincorporated associations in order to take advantage of the simplified dissolution process.

XII. Fundraising

Under most circumstances, organizational form does not affect the freedom of a public charity to design and implement a fundraising program that receives charitable contributions from both individual and corporate donors. There is, however, an important exception for the deductibility of corporate contributions made to a domestic charity, but intended for ultimate use in a foreign country.

A. Background on Charitable Deductions

Most contributions to public charities qualify the contributor for a charitable income-tax deduction under Section 170(c), making donations of money and other property to charitable organizations attractive for both individuals and corporations.²⁴⁶ The list of organizations that qualify a donor for a charitable deduction, however, is

²⁴⁶ This Section discusses only the charitable income-tax deduction. The charitable estate- and gift-tax deductions are beyond the scope of this Article. *See generally* I.R.C. §§ 2055 (estate tax), 2522 (gift tax); Treas. Reg. §§ 20.2055-1 to -6, 25.2522(a)-1 to (d)-1.

similar, but not identical to the list of tax-exempt charities under Section 501(c)(3).²⁴⁷ The major difference is that the charitable-contribution deduction is limited to those organizations “created or organized in the United States,”²⁴⁸ whereas the requirements for tax-exempt status under 501(c)(3) do not contain a geographic restriction.²⁴⁹ Therefore, an individual or corporate donor may not receive a charitable income-tax deduction for contributions made to a foreign charity, even if that foreign charity has tax-exempt status under Section 501(c)(3). This restriction would be a concern for donors interested in supporting, for example, foreign charities that aid victims of foreign civil wars, because the donors could not claim a charitable income-tax deduction under Section 170 for contributions directly to the foreign charities.

Treasury regulations, however, clarify that this restriction does not prevent *individual donors* from receiving a charitable deduction for contributions to a domestic charity that uses some or all of its funds for charitable or educational purposes in foreign countries.²⁵⁰ In Revenue Ruling 63-252, the Internal Revenue Service confirmed that Section 170(c)(2)(A) only restricts the place of a charity’s creation, not the area where contributions may be used.²⁵¹ The Service raised the concern, however, that a domestic organization must not be merely a mechanism for avoiding the requirements of Section

²⁴⁷ Chang, *supra* note 46, at 3 n.9, 4 n.10. Section 170(a)(1) allows a deduction for any “charitable contribution.” I.R.C. § 170(a)(1). Section 170(c) defines “charitable contribution” as a “contribution to or for the use of” organizations enumerated in section 170(c)(2). *Id.* § 170(c). The distinction between “to” and “for the use of” is linked to the percentage limitations on charitable contributions based upon adjusted gross income. *Compare id.* § 170(b)(1)(A) (limiting the charitable income-tax deduction to 50% of a taxpayer’s contribution base for a gift “to” a charitable organization), *with id.* § 170(b)(1)(B) (imposing a 30% limitation for all other contributions).

²⁴⁸ I.R.C. § 170(c)(2)(A).

²⁴⁹ *See* I.R.C. § 501(c)(3). Section 501(c)(3) exempts the charitable organization from federal taxation, but does not guarantee that contributions to that organization will be deductible.

²⁵⁰ Treas. Reg. § 1.170A-8(a)(1) (1972).

²⁵¹ Rev. Rul. 63-252, 1963-2 C.B. 101.

170(c).²⁵² The ruling thus provided specific examples of when contributions to a domestic organization supporting foreign charities would and would not be tax-deductible.²⁵³ In general, the Service concluded that an individual donor's gift to a domestic charity, even if given with the expectation that the funds will be transferred to a foreign charity, qualifies for the charitable income-tax deduction as long as the domestic charity is not legally obligated to transfer the funds to the specified foreign charity.²⁵⁴

To benefit from this ruling, a domestic organization formed specifically to support a foreign charity must exercise control over the funds donated. This type of organization, often called a "friends of" organization, may even limit support to a single foreign charity²⁵⁵ as long as the gifts to that charity are within the charitable purposes of the domestic organization; the domestic organization is not bound by its charter or bylaws to deliver the funds; and the domestic organization maintains some level of approval over the foreign recipient of the funds.²⁵⁶ Therefore, an individual donor to a hypothetical "Friends of Foreign Charities," a domestic charity that uses its charitable funds abroad to

²⁵² *Id.*

[I]f an organization is required for other reasons, such as a specific provision in its charter, to turn contributions, or any particular contribution it receives, over to another organization, then in determining whether such contributions are deductible it is appropriate to determine whether the ultimate recipient of the contribution is a qualifying organization. . . . Moreover, it seems clear that the requirements of Section 170(c)(2)(A) of the Code would be nullified if contributions inevitably committed to go to a foreign organization were held to be deductible solely because, in the course of transmittal to the foreign organization, they came to rest momentarily in a qualifying domestic organization.

Id.; see also Dale, *supra* note 46, at 662-63.

²⁵³ *Id.*

²⁵⁴ *Id.* ex. 4. Deductible contributions also would be permitted if the foreign organization is an alter-ego of the domestic charity, which the domestic charity formed to pursue charitable objectives in the foreign country. *Id.* ex. 5.

²⁵⁵ Rev. Rul. 66-79, 1966-1 C.B. 48.

²⁵⁶ Dale, *supra* note 46, at 663 & n.35. For discussion regarding the history of "friends of" organizations and the policy implications of restricting donations to foreign charities, see Chang, *supra* note 46, at 7-19.

support several foreign charities that aid victims of civil war and unrest, could donate funds and receive a charitable income-tax deduction, as long as Friends of Foreign Charities exercises the requisite degree of control over the funds and is not a mere conduit for those funds.

B. Corporate Contributions for Foreign Charity Work

Corporate donors, however, are treated differently. Section 170(c)(2) provides that “[a] contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph *only if it is to be used within the United States or any of its possessions.*”²⁵⁷ This geographic limitation on use applies only to corporate gifts “to a trust, chest, fund or foundation,” and not to corporate gifts to another corporation. The I.R.S. has confirmed that this language is intentional; a corporate donor may take a charitable income-tax deduction for gifts to a charitable *corporation* that uses the funds outside the United States,²⁵⁸ but may not deduct corporate gifts to a charitable trust unless the funds are used in the United States. The statute is not clear as to whether a corporate contribution to a charitable unincorporated association would be eligible for the charitable income-tax deduction. It is arguable that contributions to associations should qualify for a deduction, because unincorporated associations are included in the definition of corporation under Section 501(c)(3)²⁵⁹ and are not excluded explicitly by Section 170(c)(2). To ensure all corporate donors a tax deduction for contributions, however,

²⁵⁷ I.R.C. § 170(c)(2)(emphasis added).

²⁵⁸ Rev. Rul. 69-80, 1969-1 C.B. 65.

²⁵⁹ See I.R.C. § 7701(a)(3).

domestic charities such as Friends of Foreign Charities that wish to use funds abroad should choose to incorporate.

XIII. Real Property

Many organizations hold real property at some point in time, such as a building in which to perform its operations or ecologically sensitive land that fulfills the organization's environmental protection mission. Although there is little difference among the organizational forms, this Section addresses the ability of the three forms to deal with all aspects of real property.

A. Charitable Trust

By definition, legal title to any trust property, real or personal property, vests in the trustees for the equitable benefit of the trust, which imposes duties on the trustees.²⁶⁰ States have also increasingly recognized a trust as a separate legal entity, which has the capacity to deal with trust property on its own.²⁶¹ Regardless, a charitable trust may acquire, hold, and otherwise deal with real or personal property, whether legal title vests in the charitable trustees or in the charitable trust itself. In addition, the trust instrument may empower the charitable trustee to encumber or dispose of any real property, subject to the trustee's duties under trust law.²⁶² Again, the drafting of the trust instrument is

²⁶⁰ GEORGE T. BOGERT, TRUSTS 2-3 (6th ed. 1987) (describing the trustee as the title holder of trust property for the benefit of the beneficiary). For a description of the trustee's duties, see *supra* notes 56-72.

²⁶¹ *E.g.*, COLO. REV. STAT. § 38-30-166 (2002) (stating that a trust may "deal with any interest in property in the name of the [trust]"); UTAH CODE ANN. § 75-7-402(5) (2002) (stating that a trustee may take title to property in the name of the trust). For additional discussion of this issue, see RESTATEMENT (THIRD) OF TRUSTS § 2 reporter's notes, cmt. i, at 39-40 (Tentative Draft No. 1, 1996).

²⁶² *E.g.*, *Robinson v. Robinson*, 72 A. 883, 884-85 (Me. 1908); *Spencer v. Webb*, 57 N.E. 753, 754-55 (N.Y. 1900).

fundamental to determining the trustees powers and responsibilities with respect to real property.

B. Charitable Corporation

The statutory authority that recognizes the charitable corporation as a legal entity also grants the charitable corporation the general powers to carry out its affairs. These powers include the ability to acquire, hold, and dispose of all or any part of its real or personal property.²⁶³ All charitable corporations, whether governed by a not-for-profit statute or general corporate law, enjoy these powers.

C. Charitable Unincorporated Association

At common law, an unincorporated association was not recognized as a separate legal entity and therefore could not acquire, hold, or convey real or personal property.²⁶⁴ When property was transferred to an association, courts decided, in the absence of statutory authority, whether to disregard the transfer or devise a solution to this common-law problem. Some courts responded by recognizing the unincorporated association as the legal owner of the property,²⁶⁵ while others treated the transfer of property as made in trust to the association's members or others for the benefit of the association as a whole.²⁶⁶

²⁶³ E.g., REVISED MODEL NONPROFIT CORP. ACT § 3.02(4), (5) (1987) (granting corporations the power “(4) to purchase, receive, lease, or otherwise acquire, and own, hold, improve, use, and otherwise deal with, real or personal property, or any legal or equitable interest in property, wherever located; (5) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property”); see also N.Y. NOT-FOR-PROFIT CORP. LAW § 202(4), (5) (McKinney 2002).

²⁶⁴ E.g., *Popovich v. Yugoslav Nat'l Home Soc'y*, 18 N.E.2d 948, 951 (Ind. App. 1939); J.E. Keefe, Jr., *Power and Capacity of Members of Unincorporated Association, Lodge, Society, or Club to Convey, Transfer, or Encumber Association Property*, 15 A.L.R.2d 1451, 1451-52 (1951); see also *supra* notes 12-14 and accompanying text.

²⁶⁵ See, e.g., *United Bhd. of Carpenters & Joiners v. Stephens Broad. Co.*, 39 So. 2d 422, 423-24 (La. 1949) (interpreting state statute).

²⁶⁶ *Venus Lodge No. 62 v. Acme Benevolent Ass'n*, 58 S.E.2d 109, 112 (N.C. 1950); *In re Anderson's Estate*, 571 P.2d 880, 882 (Okla. Ct. App. 1977).

Some state legislatures addressed the problem by creating statutory authority, either granting legal status to unincorporated associations (thus recognizing the ability to acquire and hold property),²⁶⁷ or simply providing associations with limited rights to acquire, hold, or transfer real or personal property.²⁶⁸ However, unless a charitable unincorporated association is formed in a state that has adopted the Uniform Act, the organization must carefully check both state and common law to unearth authority as to whether the association itself may acquire, hold, or transfer real property.

The Uniform Act solves the problem by reversing the common-law rule.²⁶⁹ Under the Uniform Act, “a nonprofit association in its name may acquire, hold, encumber, or transfer an estate or interest in real or personal property.”²⁷⁰ It further provides for a “Statement of Authority as to Real Property.”²⁷¹ This statement, which only applies to the lease, encumbrance, or other disposition of a real property interest held by the charitable unincorporated association, is not necessary under the Uniform Act, but the statement does document the authority of particular persons within the association to transfer or otherwise deal with the association’s real property.²⁷² Thus, an association organized in a state that has adopted the Uniform Act is in the same position as a charitable corporation or charitable trust with regard to real and personal property.

²⁶⁷ *Supra* notes 15-29 and accompanying text.

²⁶⁸ *See* CAL. CORP. CODE § 20001 (West 2002); N.Y. EST. POWERS & TRUSTS LAW § 3-1.3(b) (McKinney 2002).

²⁶⁹ UNIF. UNINCORPORATED NONPROFIT ASS’N ACT § 4, cmt. 1 (1996).

²⁷⁰ *Id.* § 4(b) & cmts. 1-5. In addition, the Uniform Act clarifies that the charitable unincorporated association “may be a beneficiary of a trust or contract, a legatee, or a devisee.” *Id.* § 4(c).

²⁷¹ *Id.* § 5.

²⁷² *Id.* § 5 & cmts. 2, 6-7. Although the Uniform Act does not provide exact guidance as to the process, it contemplates that the statement of authority would be filed or recorded in the office where the real property record is located, so that during a title search, purchasers will have notice of the authority (or lack thereof) of those acting on behalf of the charitable unincorporated association. *See id.* cmts. 3, 9.

XIV. Commercial Activities

Although it may seem counterintuitive, an organization may qualify for tax-exempt status under Section 501(c)(3) even if it operates a trade or business, either related or unrelated to its charitable activities. Treasury Regulations explicitly state that:

An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized and operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.²⁷³

An organization may therefore operate a related trade or business as a substantial part of its activities. Furthermore, without risking its tax exempt status, an organization may undertake a trade or business unrelated to its exempt purpose, as long as the unrelated commercial activities are not more than an insubstantial part of the organization's activities.²⁷⁴

The income derived from an “unrelated trade or business,” however, will be subject to taxation under Section 511.²⁷⁵ Section 512(a)(1) defines unrelated business taxable income as “the gross income derived by any organization from any unrelated trade or

²⁷³ Treas. Reg. § 1.501(c)(3)-1(e)(1) (as amended in 1990).

²⁷⁴ *Id.* § 1.501(c)(3)-1(c)(1); Rev. Rul. 78-385, 1978-2 C.B. 174. There is no definitive statement of when the organization's involvement in unrelated commercial activities will rise to “exceed[] the benchmark of substantiality” so that tax-exempt status might be denied or revoked, although many cases and private letter rulings have addressed it under individual circumstances. *See, e.g.,* Orange County Agric. Soc'y v. C.I.R., 893 F.2d 529, 533 (2d Cir. 1990).

²⁷⁵ I.R.C. § 511(a). Before 1950, a “destination of income test” prevailed with respect to income from businesses; as long as the revenue raised from the operation of a business was used for exempt purposes, it did not jeopardize the organizations tax exemption. *See* Jonathan A. Small, *Unrelated Business Income Tax: Structure, Current Problems, Planning Opportunities and Legislative Developments*, 307 PLI/TAX 171, 180 (November 1-2, 1990) (citing *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924)). However, because of its “perception that tax-exempt organizations were permitted an unfair business advantage when competing against businesses that were required to pay taxes on their earnings,” Congress enacted the unrelated business income tax (“UBIT”) in 1950. *Id.* at 181. For history on the rationale behind the

business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business.”²⁷⁶ Whether an activity is a regularly carried on unrelated trade or business depends on the facts and circumstances. An activity is a trade or business “if it is pursued with a profit motive or is conducted in a commercial manner.”²⁷⁷ Treasury Regulations state that “specific business activities of an exempt organization will ordinarily be deemed to be ‘regularly carried on’ if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.”²⁷⁸ Finally, an organization can avoid the imposition of the tax if the business is “substantially related” to the organization’s exempt purposes.²⁷⁹

enactment of the UBIT, see Harvey P. Dale, *About the UBIT*, NEW YORK UNIVERSITY, 18TH CONFERENCE ON TAX PLANNING FOR 501(C)(3) ORGANIZATIONS § 9.02 (1990).

²⁷⁶ I.R.C. § 512(a)(1). Section 513 defines an unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Id. § 513. Section 512 provides for the “modification” of unrelated business income by excluding certain investment income, royalties, and rents among other deductions. *Id.* § 512(b); Treas. Reg. § 1.512(b)-1 (as amended in 1992). For further explanation of these modifications, see Small, *supra* note 275, at 200. For a more detailed review of the requirements for taxing unrelated business income, see generally Deidre Dessingue Halloran, *UBIT Update*, 36 CATH. LAW. 39 (1995); Small, *supra* note 275; John M. Strefeler & Leslie T. Miller, *Exempt Organizations: A Study of Their Nature and the Applicability of the Unrelated Business Income Tax*, 12 AKRON TAX. J. 223 (1996).

²⁷⁷ Strefeler & Miller, *supra* note 276, at 249. Section 513(c) defines trade or business as “any activity which is carried on for the production of income from the sale of goods or the performance of services.” I.R.C. § 513(c).

²⁷⁸ Treas. Reg. § 1.513-1(c)(1) (as amended in 1983). Examples in the Regulation focus on how similar the activity is to one also carried on for-profit. *E.g.*, *id.* § 1.513-1(c)(2). For example, if an organization sells Christmas cards only in the months immediately before Christmas, it may be considered “regularly carried on” because the regular conduct of that business for profit only takes place during those particular months. Strefeler & Miller, *supra* note 276, at 249-50.

²⁷⁹ This facts-and-circumstances test includes the examination of such factors as the size and extent of activities, whether any goods sold are a byproduct of the organization’s exempt function, and whether goods are sold in “substantially the same state” as they are on completion of the exempt functions. Treas. Reg. § 1.513-1(d). The most often cited example for the last factor is a dairy exempt from tax under the category of scientific research and that produced milk, cream, and ice cream. *Id.* § 1.513-1(d)(4)(ii). Because the ice cream was processed by one component of the dairy, the gross income from that component was subject to

Even substantial unrelated business income may be exempt from taxation under specific statutory exceptions.²⁸⁰ An important exception for many organizations is for any unrelated trade or business in which substantially all the work is performed by volunteers, such as a church thrift shop.²⁸¹

After considering all the exemptions (and taking into account the deductions allowed by Section 512), an organization with \$1000 or more of unrelated business income must calculate and report the appropriate tax on I.R.S. Form 990-T, “Exempt Organizations Business Income Tax Return.”²⁸² Choice of form affects the tax rate for unrelated business income. Section 511(a) imposes the corporate rates on the unrelated business income of charitable corporations and charitable unincorporated associations.²⁸³ The corporate rates range from 15% for below \$50,000 of taxable income to 34% for income in excess of \$75,000 but less than \$10 million.²⁸⁴ Section 511(b)(1) imposes the trust rates on the unrelated business income of charitable trusts.²⁸⁵ The trust rates start at 15% for taxable income less than \$2050, but rise quickly to \$2596 plus 35% of the excess

UBIT. *Id.*; see also Rev. Rul. 76-94, 1976-1 C.B. 171. For examples of activities that are substantially related to an exempt organization’s purpose, see Strefeler & Miller, *supra* note 276, at 251.

²⁸⁰ I.R.C. § 513(a)(1); Treas. Reg. § 1.513-1(e).

²⁸¹ *Id.*; see also Halloran, *supra* note 276, at 45.

²⁸² See I.R.S. PUB. 598, TAX ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS (rev. Mar. 2000).

²⁸³ I.R.C. § 511(a)(1), (2).

²⁸⁴ Section 11(b)(1) sets the corporate rate as

- (A) 15 percent of so much of the taxable income as does not exceed \$50,000,
- (B) 25 percent of so much of the taxable income as exceeds \$50,000 but does not exceed \$75,000,
- (C) 34 percent of so much of the taxable income as exceeds \$75,000 but does not exceed \$10,000,000, and
- (D) 35 percent of so much of the taxable income as exceeds \$10,000,000.

In the case of a corporation which has taxable income in excess of \$100,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (i) 5 percent of such excess, or (ii) \$11,750.

Id. § 11(b)(1).

²⁸⁵ See *id.* § 511(b)(1), (2).

over \$10,050.²⁸⁶ The different rates may have a substantial impact on organizations with significant unrelated business income.

An example illustrates the difference in tax liability between a charitable corporation and a charitable trust. If an organization had \$100,000 of net unrelated business taxable income, the tax liability for a corporation or unincorporated association would be calculated as follows:

15% of \$50,000 = \$7500
25% of the next \$25,000 = \$6250
34% of the last \$25,000 = \$8500
Total = \$22,250

The tax liability for a charitable trust would be calculated as follows:

\$2596 plus 35% of \$89,950 = \$34,078

Therefore, an organization that anticipates generating substantial unrelated business income may wish to incorporate. For example, if the Art Theater housed a gift shop where the art and other related items were sold, the net income from the sale of goods, unless related to the organization's exempt purposes (i.e., the promotion of the theater), will be subject to unrelated business income tax, and the hypothetical Art Theater should choose the corporate form to lessen its tax burden.

The unrelated business income tax may also be an issue if the organization holds stock in an S corporation. The Small Business Protection Act of 1996 amended the S

²⁸⁶ Section 1(e) sets the trust rates according to the following table (adjusted for taxable years beginning in 2006 by Rev. Proc. 2005-70 (IRB 2005)):

If taxable income is:	The tax is:
Not over \$2,050	15% of taxable income.
Over \$2,050 but not over \$4,850	\$307.50, plus 25% of the excess over \$2,050.
Over \$4,850 but not over \$7,400	\$1,007.50, plus 28% of the excess over \$4,850.
Over \$7,400 but not over \$10,050	\$1,721.50, plus 33% of the excess over \$7,400.
Over \$10,050	\$2,596, plus 35% of the excess over \$10,050.

corporation provisions of the Internal Revenue Code to allow 501(c)(3) organizations to be eligible shareholders of an S corporation.²⁸⁷ However, S corporation stock is by definition an interest in an unrelated business.²⁸⁸ Therefore, any income to the exempt organization as a shareholder of the S corporation is subject to unrelated business income tax, as is any gain realized on disposition of the stock. Organizations that anticipate holding S corporation stock, thus, should consider incorporating in order to receive lower tax rates on the unrelated business income from the stock.

XV. Conclusion

Each charitable organization is unique with respect to its goals and purposes; there is no set model for determining the appropriate organizational form. The selection of a form should be an integral step that founders of an organization undertake before creating a nonprofit entity. In choosing a form, organizations must balance each factor, considering not only current goals and needs but also future plans and activities. To illustrate the process that fledgling organizations should undertake before formation, we will revisit the hypothetical organizations referenced throughout this Article.

Because Services for the Homeless intends to rely on volunteers during its infancy stage and expects to expand its operations substantially in later years, the three factors of primary importance are volunteer liability, management liability, and modification. The liability of volunteers is governed by state statute and the Volunteer Protection Act, so

Id. § 1(e).

²⁸⁷ Small Business Protection Act of 1996, Pub. L. No. 104-188, § 1316, 110 Stat. 1755 (codified as amended at I.R.C. § 1361(c)(6)); Jasper L. Cummings, Jr. & Samuel P. Starr, *The Impact of the New S Corporation Revisions*, 85 J. TAX'N 197, 205 (1996).

²⁸⁸ I.R.C. § 512(e).

Services for the Homeless should consult local counsel in the areas it may operate to determine whether volunteer liability will affect choice of form. The remaining two factors suggest that Services for the Homeless should incorporate. First, the corporate form allows for greater predictability than unincorporated associations with respect to liability issues for directors and officers, especially in states that have not adopted some form of the Uniform Act. Second, the corporate form would be easier to modify or dissolve than a charitable trust, unless the trust instrument explicitly provides means for modification and dissolution.

After-school Program for Kids would similarly be concerned with liability issues because it will provide direct services for children, and those liability issues weigh in favor of the corporate form. The potential donation of a building raises other issues, requiring that the organization be legally capable of holding property and that the organization form quickly to meet the donor's demands. Because some state statutes require approvals for the formation of charitable corporations, an unincorporated association or trust could be formed more quickly; the nonprofit always could reorganize later as a charitable corporation. However, if the organization does contemplate forming as a charitable unincorporated association, After-school Program for Kids must ascertain whether its state has adopted the Uniform Act's provision that associations may hold title to real property. If the state has no such provision, After-school Program for Kids must form as a corporation or trust.

Save the Wetlands faces similar issues with respect to ease and speed of formation and capacity to hold property as After-school Program for Kids. Save the Wetlands also must consider its desire to dissolve or change its purpose after averting the immediate

crisis of development on the wetlands. Because a charitable corporation may hold property and can change purposes or dissolve with greater ease than a charitable trust, the corporate form should be the appropriate choice for Save the Wetlands. However, the organization must broadly state its purposes in its organizational documents to allow for more flexibility to expand or modify its purposes over time.

The founder of Art Theater would like the flexibility to manage the organization while limiting his day-to-day involvement. Additionally, he is concerned that the gift shop's income will be subject to unrelated business income tax. If the founder incorporates Art Theater, he will not be held to a charitable trustee's high standard of care. Furthermore, any unrelated business income will be subject to the lower corporate tax rate.

In some circumstances, one factor may outweigh all others. For example, if Friends of Foreign Charities wishes to raise funds in the United States to support activities or organizations abroad, it will want to incorporate. Unless there is some other overriding issue, the corporate form is the only way to ensure that all of Friends of Foreign Charities' supporters will be able to make tax-deductible contributions.

Individuals interested in forming a charitable organization should conduct a similar exercise. Founders should consider which factors will be important to the organization's operations and then determine how the forms differ with respect to the relevant factors. If important issues suggest different forms, the founders must prioritize the factors or determine if the differences could be eliminated by carefully drafting the organizational documents.