"... an exceptional resource for nonprofit boards and leaders."
—David O. Renz, Beth K. Smith/Missouri Chair in Nonprofit Leadership, Midwest Center for Nonprofit Leadership, University of Missouri, Kansas City

The Handbook of NONPROFIT GOVERNANCE

BOARDSOURCE®
Building Effective Nonprofit Boards

THE HANDBOOK OF NONPROFIT GOVERNANCE

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BOARDSOURCE®

Building Effective Nonprofit Boards

BoardSource is dedicated to advancing the public good by building exceptional nonprofit boards and inspiring board service.

BoardSource was established in 1988 by the Association of Governing Boards of Universities and Colleges (AGB) and Independent Sector (IS). In the early 1980s, the two organizations had conducted a survey and found that although 30 percent of respondents believed they were doing a good job of board education and training, the rest of the respondents reported little, if any, activity in strengthening governance. As a result, AGB and IS proposed the creation of a new organization whose mission would be to increase the effectiveness of nonprofit boards.

With a lead grant from the Kellogg Foundation and funding from five other donors, BoardSource opened its doors in 1988 as the National Center for Nonprofit Boards. It had a staff of three and an operating budget of $385,000. On January 1, 2002, BoardSource took on its new name and identity. These changes were the culmination of an extensive process of understanding how we were perceived, what our audiences wanted, and how we could best meet the needs of nonprofit organizations.

Today BoardSource is the premier voice of nonprofit governance. Its highly acclaimed products, programs, and services mobilize boards so that organizations fulfill their missions, achieve their goals, increase their impact, and extend their influence. BoardSource is a 501(c)(3) organization.

BoardSource provides

- Resources to nonprofit leaders through workshops, training, and an extensive Web site (www.boardsource.org)
- Governance consultants who work directly with nonprofit leaders to design specialized solutions to meet an organization's needs
- The world's largest, most comprehensive selection of material on nonprofit governance, including a large selection of books and CD-ROMs
- An annual conference that brings together approximately nine hundred governance experts, board members, and chief executives and senior staff from around the world

For more information, please visit our Web site at www.boardsource.org, e-mail us at mail@boardsource.org, or call us at 800-883-6262.

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INTRODUCTION

Service on a nonprofit board was once perceived as an honorary role requiring nothing more than periodic attendance at meetings and generous annual donations. But vibrant growth in the nonprofit sector has helped to change the nature of board service. Board members need to do more than just show up. They must understand and promote the organization's work, define measures of success, and assess how well the organization performs, using both subjective and objective standards. They must generate and allocate resources, hire the chief executive, develop plans, establish policies and programs, and monitor activities—all with a sharp focus on producing meaningful results.

Within these broad roles, board members have many functions. They are guardians of the mission, they ensure compliance with legal and financial requirements, and they enforce ethical guidelines for their organization. They are policymakers, fundraisers, ambassadors, partners with the chief executive, and strategic thinkers. They monitor progress, evaluate the performance of the organization and the chief executive, and demonstrate integrity in everything they do on behalf of the organization. Because of their many roles, board members need more than enthusiasm for a cause, passion for a mission, or just good intentions. They need to understand all of their stewardship responsibilities and perform all of their duties.

Board service entails serious obligations, to be sure, but it can also deliver immense satisfaction. A board that knows what is expected of it and performs at

the highest level is a strategic resource for its organization and chief executive. And ultimately, this commitment by dedicated board members translates into mission impact in our communities.

About This Book

The Handbook of Nonprofit Governance is a comprehensive overview of the principles and practices of nonprofit boards. To compile this handbook, BoardSource drew on its extensive selection of books, articles, and topic papers by leading experts on nonprofit governance.

The book is organized in two parts. Part One (Chapters One through Five) addresses basic governance history, roles, and structures. Part Two (Chapters Six through Sixteen) examines nonprofit governance practices, drawing on the experience and wisdom of BoardSource experts to review basic approaches to board responsibilities and board self-management. Consulting the handbook provides answers to the following questions:

What is the nonprofit sector, and how does governance fit in? Chapters One and Two review the history of the nonprofit sector, its function in society, and the basic tenets of nonprofit governance.

What roles do nonprofit boards serve? Chapter Three explains the governance roles of the full board and of individual board members, broadly described as setting organizational direction, ensuring the necessary resources, and providing oversight. It links to other chapters in this handbook that explore elements of these governance roles in greater depth. Chapter Four examines board structure, including board size and the functions of committees, task forces, and other work groups. Chapter Five describes the board–chief executive relationship and offers suggestions to ensure its success.

Part Two examines nonprofit governance practices, drawing on the experience and wisdom of BoardSource experts to review basic approaches to board responsibilities and board self-management:

How does a nonprofit organization build and sustain a strong, active board? Chapter Six reviews the cyclical process of finding the best people, bringing them onto the board, and then creating an environment for board service that invites them to reach their full potential as board members. Building a board involves more than enlisting new members and training them. This chapter describes the full cycle: identifying, cultivating, and recruiting board members; providing orientation; involving all board members in meaningful work; promoting continuing education; evaluating the effectiveness of the full board and of individuals;

refreshing the board through term limits and regular rotation; and celebrating board accomplishments.

What are the legal and ethical responsibilities of the board and its members? Governance is serious business, with a set of duties that are defined by law. Chapter Seven opens with a discussion of fiduciary responsibility—the board's obligations for financial accountability and effective oversight of the organization. Exceptional boards not only follow legal requirements, but also ensure that the organization's work is conducted in an ethical, open, and responsive manner. Legal and ethical compliance, conflict of interest, legal liability, and the concepts of private benefit and private inurement are among the issues covered in this chapter.

How does the board carry out its financial oversight responsibilities? Ultimately, the board is responsible for the financial viability, the program success, and the survival of the organization. Chapter Eight reviews what board members need to know about financial integrity and solvency, safeguards and procedures to protect the organization, and signs of financial trouble. It explains the implications of the Sarbanes-Oxley Act for nonprofits, the importance of an external audit, and the financial systems that organizations need for safe, efficient operations.

What is the board's role in fundraising? Fundraising begins with the board, because board members understand the organization well and are committed to helping it fulfill its mission. Chapter Nine outlines the board's involvement in fundraising, step by step. Joining with staff to generate necessary resources, the board provides strategic guidance and direction, participates as donors and as fundraisers, and is responsible for stewardship and oversight of the funds raised. Beginning with an explanation of board members' personal obligation for giving, the chapter reviews fundraising types, policies, and techniques, with tips for raising board members' comfort level for joining in this important activity.

How does the board engage in strategic thinking and participate in strategic planning? Strategic thinking and planning move an organization toward fulfilling its mission and creating its future. Both processes—as described in Chapter Ten—are potentially enriching and energizing for the board. When strategic thinking becomes a habit, board meetings are dynamic, discussions are challenging and thought provoking, and the board identifies crucial issues that lead to more relevant, timely, and constructive decisions. This chapter outlines the rationale for strategic planning, describes basic steps in the process, and emphasizes the need to blend planning and evaluation.

What does the board contribute to communications and outreach? For nonprofit boards, strategic communications involves big-picture thinking, a clear understanding of appropriate roles, and hands-on participation when appropriate. Chapter Eleven reviews how board members can contribute to the staff's work through

public speaking, relationship building, and advocacy. It explains lobbying and political activity by nonprofits, and it addresses communications during a crisis or controversy.

How do boards ensure effective chief executive transitions? The board's responsibility for hiring and supporting the chief executive can have an extraordinary impact on organizational effectiveness. Chapter Twelve explains that there's more to this responsibility than executive search. It begins with the proactive step of having a succession plan and compensation policy in place. This chapter describes the steps in a careful, thorough executive search, describes some characteristics to look for, and emphasizes the essential support that new chief executives need from their boards.

Why is evaluation important, and how is the board involved? Evaluation is a learning tool that, when embedded in an organization's culture, promotes the achievement of mission. Chapter Thirteen stresses the board's role in promoting continuing evaluation. Measuring organizational effectiveness, self-assessment for the full board, self-assessment for individual board members, and performance evaluation for the chief executive are all board responsibilities, described in this chapter. The staff is also responsible for evaluating an organization's core programs and practices.

How do bylaws and policies promote sound board decisions? Chapter Fourteen reviews the details of a nonprofit organization's governing documents (bylaws) and operating principles (policies). It explains the context for bylaws and policies and provides an overview of the issues and areas they should address. The chapter includes recommendations and examples to serve as a starting point for the documents that each organization should tailor to its own needs and circumstances.

What are the ingredients of a productive board meeting? At meetings, the board carries out its role as policy maker, sets direction for the organization, defines and follows its own ethical guidelines, oversees operations, and takes care of its own well-being. Chapter Fifteen offers recommendations for planning fast-paced, efficient meetings while maintaining the spirit of teamwork and collegiality among board members. Topics include deciding on frequency of meetings, developing an agenda, facilitating the meeting, preparing minutes, holding executive sessions, and evaluating the meeting.

How do board dynamics influence board effectiveness? The dynamics of working together on behalf of the organization can be complex, but boards need to promote a working environment that encourages collaboration, partnership, engagement, trust, respect, flexibility, and interaction. Chapter Sixteen addresses five key issues in board dynamics: building trust to support collaborative governance, developing a culture of inquiry, recognizing and avoiding micromanagement,

ensuring independent-mindedness, and dealing with the problem of troublesome board members.

Reflecting on board dynamics is a fitting way to conclude this handbook. While many principles and practices of nonprofit governance are well established, the essence of board interactions is often more difficult to express. When all is said and done, the board is a group of individuals with a collective commitment. How they engage with one another can make the difference between governance that is simply good and governance that is truly exceptional. The stakes are high, but the dynamic role of nonprofit organizations in our society attests to the fact that the women and men who serve on nonprofit boards fulfill their responsibilities with seriousness of purpose, dedication to service, and passion for their organizations' missions.

PART ONE

GOVERNANCE PRINCIPLES, ROLES, AND STRUCTURE

CHAPTER ONE

IN THE SPIRIT OF SERVICE: INTRODUCTION TO THE NONPROFIT WORLD

The only ones among you who will be really happy are those who will have sought and found how to serve.

—Albert Schweitzer

Virtually every society shows its voluntary spirit and philanthropic instinct by creating informal community groups, charitable nongovernmental organizations, or faith-based organizations and places of worship. In countries around the world, nonprofits are a vibrant, essential element of national life. They struggle to reduce poverty and bring an end to homelessness. They strive to build safe places to learn and play, create inspiring art and music, and protect natural resources.

Nonprofit organizations span a wide spectrum of mission areas, resources, values, history, and stakeholders—from small, local homeless shelters to large, international trade associations; from community foundations operating within a geographic region to educational institutions that attract students from around the country. Their funding may come from just a handful of sources or from an array of charitable contributions, membership dues, grants, fees from programs and services, and more. According to the Internal Revenue Service, the United States alone has more than 1.8 million voluntary, nonprofit, and nongovernmental organizations, with more recognized every month by the federal government as tax-exempt entities.

Economic life in the United States and many other countries consists of three sectors:

- *Public-sector organizations* exist to serve the public good. They are part of governmental structures and are financed largely by tax revenues.

- *Private-sector organizations* exist to produce a profit for their owners. To do so they must meet the needs of a constituency who will pay for their goods or services.
- *Nonprofit-sector organizations* exist to serve a social purpose, a constituency, or a cause. To do so successfully, they must earn or raise sufficient funds to cover expenses and safeguard the organization's future. They are not prohibited from creating excess revenue over expenses, but such surplus must be used to support the organization's mission, not to be distributed as private gain. In nonprofit organizations there are no individual owners who can claim organizational assets for their own benefit.

An Overview of the Nonprofit Sector

The nonprofit sector sometimes is called the not-for-profit sector, the third sector, the independent sector, the philanthropic sector, the voluntary sector, or the social sector. Outside the United States, nonprofits are often called nongovernmental organizations (NGOs) or civil society organizations.

These other names emphasize the characteristics that distinguish nonprofits—*voluntary sector* to acknowledge the importance of volunteers and voluntary action, *independent sector* to distinguish nonprofits from business and government, and *social sector* to underscore how the activities of nonprofits enhance the social fabric of our country.

The nonprofit sector in the United States is vast and diverse and touches all our lives. The nonprofit organizations in this country in 2008 employed 10.5 percent of the country's work force—close to ten million paid workers.

Almost all nonprofits are exempt from federal, state, and local income taxes; state and local property taxes; and state and local sales taxes. They are, however, required to pay taxes on income derived from activities that are unrelated to their mission. Nonprofits are not exempt from withholding payroll taxes for employees. Section 501(c) of the Internal Revenue Code, which outlines the types of organizations eligible for tax exemption, lists more than twenty-five classifications of nonprofits, which include the major subcategories described in the following section.

Public Charities

Nonprofits that are exempt under Section 501(c)(3) of the tax code are often called charities, but these organizations do far more than provide free care and services to the needy. Hospitals, museums, orchestras, independent schools, public

television and radio stations, and many other organizations are 501(c)(3) nonprofits. Most U.S. nonprofits are classified as public charities, and in 2008 nearly 1.2 million were registered with the Internal Revenue Service.

To be recognized as a public charity, a nonprofit must be organized and operated for purposes that are beneficial to the public interest. These purposes include

- Relief of the poor, distressed, or underprivileged
- Advancement of religion
- Advancement of education and science
- Creation or maintenance of public buildings or monuments
- Lessening of the burden of government
- Elimination of prejudice and discrimination
- Defense of human and civil rights
- Combating of community deterioration and juvenile delinquency

A public charity must be able to show broad public support, rather than funding from an individual source. Upon dissolution, its assets must be distributed to another 501(c)(3) charity. It is not allowed to engage in any partisan political activity. Lobbying is accepted but cannot be a substantial part of its activities. Individuals and corporations that give money to these organizations can deduct the value of gifts from their taxable income, provided they file itemized tax returns.

Foundations

Many individuals, families, businesses, and communities establish foundations as a way to support causes and programs that benefit society. Foundations, which are also 501(c)(3) charitable nonprofits, are one of the most complex components of the nonprofit sector. As a result of federal legislation passed in 1969, private foundations are subject to more stringent regulation and reporting requirements than other types of nonprofits. They are required to make grants equal to at least 5 percent of their net investment assets each year, and they generally pay a 2-percent excise tax on net investment earnings. There are more than seventy thousand foundations in the United States:

- *Private* foundations usually have a single source of funding (an individual, a family, or a business), and use income from investments to make grants to charitable nonprofit organizations. The Ford Foundation, the Carnegie Corporation of New York, and the W. K. Kellogg Foundation are well-known examples.

Corporate foundations are private foundations that receive funding from—and make grants on behalf of—a corporation. The MetLife Foundation and the American Express Foundation are examples. Many corporations have in-house corporate giving programs instead of or in addition to corporate foundations.

- *Operating* foundations are "hybrid" foundations that use the bulk of their resources to carry out their own charitable programs, while also making grants to other charities. The Carnegie Endowment for International Peace and the J. Paul Getty Trust are examples of operating foundations.
- *Community* foundations pool the resources of many donors and focus their grantmaking on a particular city or region. The Cleveland Foundation and the New York Community Trust are examples of community foundations. The IRS classifies community foundations as publicly supported charities, not private foundations. These groups are not subject to excise taxes or distribution requirements like private foundations, and donations made to them by individuals are tax deductible.

Some nonprofits, such as hospitals and public colleges, create related or supporting 501(c)(3) organizations that may be called foundations; these groups are fundraising (rather than grantmaking) organizations, and they typically raise money from a broad range of donors and then distribute the proceeds to the parent organization. In addition, some other charities include the word *foundation* in their names even though they are not considered foundations according to legal definitions.

Social Welfare Organizations

To be tax-exempt as a 501(c)(4) organization, a nonprofit must not be organized for profit and must be operated exclusively for the promotion of social welfare. This means that the organization must operate primarily to further, in some way, the common good and general welfare of the people of the community (such as by bringing about civic betterment and social improvements). Nonprofits such as the NAACP, the National Rifle Association, and the National Organization for Women are examples of social welfare or advocacy organizations. Contributions to 501(c)(4) organizations are not tax deductible, and 501(c)(4) nonprofits have greater latitude to participate in legislative advocacy, lobbying, and political campaign activities.

Professional and Trade Associations

Organizations whose missions focus on the advancement of the conditions of a particular trade or the interests of a community, an industry, or a profession generally qualify for tax exemption under Section 501(c)(6) of the tax code.

Although contributions to these organizations are not tax deductible, membership dues may be deductible as business expenses.

Many people believe that nonprofits receive most of their funds from private contributions. In reality, many nonprofits (hospitals and universities are good examples) generate revenue by charging fees for the services they provide, earning interest on investments, or producing and selling goods. Many organizations also receive funding from government, either in the form of outright subsidies or for providing services on a contract basis.

The idea of the nonprofit sector may be abstract, but the sector's role in our society is tangible and easily recognized. Freed from the profit motive that dominates business and from the constraints of government, the nonprofit sector is a forum for the creation and dissemination of new ideas, an efficient vehicle for delivering social services, and a guardian of our environment, values, and heritage.

Monitoring, Regulating, and Governing Nonprofits

Nonprofits are not immune from damage that can be caused by unscrupulous and fraudulent solicitors, financial improprieties, and executives and board members who care more about their own financial welfare than the mission of the organization. Problems, when they do arise, are particularly disturbing because of the nature of nonprofits themselves—organizations created to provide some public benefit.

Most people are familiar with the mechanisms that safeguard the integrity of government and business. Disenchanted voters can throw politicians out of office, and the branches of government view each other with watchful eyes. Businesses have shareholders or owners and are monitored by government agencies such as the Securities and Exchange Commission and the Occupational Safety and Health Administration. The media monitor both sectors and are quick to point out cases of corruption and poor performance.

Far fewer people understand how nonprofits are monitored and regulated. For much of its history, the nonprofit sector has operated outside the realm of harsh public scrutiny. No government agency exists exclusively to monitor the activities of nonprofits, most nonprofits aren't required to hold public meetings, and few journalists report on nonprofits with the same depth and focus devoted to business and government.

Nevertheless, nonprofits have many lines of defense against fraud and corruption:

- *Boards*. All nonprofits are governed by a board of directors or trustees (there's no real difference)—a group of volunteers that is legally responsible for making

sure the organization remains true to its mission, safeguards its assets, and operates in the public interest. The board is the first line of defense against fraud and abuse.

- *Private watchdog groups*. Several private groups (which are themselves nonprofits) monitor the behavior and performance of other nonprofits. Some see their mission as advising donors who want to ensure that their gifts are being used effectively; others are industry or "trade" groups that provide information to the public and encourage compliance with generally accepted standards and practices.
- *State charity regulators*. The attorney general's office or some other part of the state government maintains a list of registered nonprofits and investigates complaints of fraud and abuse. Often the state attorney general serves as the primary investigator in cases of nonprofit fraud or abuse. Almost all states have laws regulating charitable fundraising.
- *Internal Revenue Service*. A small division of the IRS (the exempt organizations division) is charged with ensuring that nonprofits comply with the eligibility requirements for tax-exempt status. IRS auditors investigate the financial affairs of thousands of nonprofits each year. As a result, a handful have their tax-exempt status revoked; others pay fines and taxes. In 1996, legislation authorized the IRS to penalize individuals who abuse positions of influence within public charities and social welfare organizations. Before that change, the only weapon available to the IRS was to revoke tax-exemption, which resulted in the denial of service to the clients and constituents the organization was created to help. Because they fall short of revocation of tax-exempt status, these provisions are called intermediate sanctions.
- *Donors and members*. Some of the most powerful safeguards of nonprofit integrity are individual donors and members. By giving or withholding their financial support, donors and members can cause nonprofits to reappraise their operations.
- *Media*. Most of the major scandals involving nonprofit organizations in recent years have come about as a result of media investigations and resulting news stories. Although many nonprofit leaders feel misunderstood or even maligned by negative media coverage, this media watchdog role has resulted in increased awareness and accountability throughout the sector.

Starting a Nonprofit Organization

Americans are known for their pioneer temperament, community spirit, and help-thy-neighbor attitude. We show social consciousness, concern for the

environment, commitment to saving historic sites, responsibility to advocate individual rights, and an urgency to do this all as a personal vocation for a cause. This commitment often leads to a desire to start a nonprofit organization.

Forming a nonprofit requires more than passion or devotion. One needs understanding of financial management, knowledge of legal requirements, managerial skills, community relations, familiarity with issues in the field, friends and supporters, and more than anything, time, energy and endless patience.

Questions to Ask Before Starting a Nonprofit

1. Is somebody already doing what I would like to do?

   There is no sense in duplicating an effort that already exists. Maybe there is a possibility of working with an existing organization as a consultant, fundraiser, employee, direct-service volunteer, or board member.

2. Is this the right time and place for starting a new organization?

   How will the idea be received by the community? Is there a true need for my services? Have I tested the idea, or am I the only one who thinks it is essential? Who are the constituents?

3. How would I finance my organization?

   Do I have the necessary seed money? If not, where can I get the initial funding? Have I developed relations with the leaders in the community? How much fundraising will I have to do? Do I understand that grant funding is highly competitive and therefore not dependable? Should the services of my organization be free, or is this how I will produce earned income? Should I form a membership organization and charge a fee? Could I associate my group with an already established organization?

4. Do I understand the steps of forming a nonprofit organization?

   There are a multitude of procedures to take care of before a nonprofit organization is ready to function: forming a board, drafting bylaws, developing a strategic plan, incorporating, applying for tax-exempt status, securing funding, setting up an accounting system, locating an office, applying for licenses, recruiting staff, and so on.

5. Are my financial ambitions appropriate for the cause?

   Running a nonprofit or serving as a nonprofit board member is not going to fill my pockets with cash. Staff members can be compensated justly; board members normally serve as volunteers and should not seek any personal benefit from this affiliation. Will I be content to serve and work for my cause, get satisfaction from the results of my labor, and always put my organization first before thinking of my personal gain?

To be effective at fulfilling its purpose, every nonprofit organization must have a carefully developed structure and operating procedures. Good governance starts with helping the organization begin on a sound legal and financial footing in compliance with the numerous federal, state, and local requirements affecting nonprofits.

1. *Determine the purpose of the organization.* Every organization should have a written statement that expresses its reason for being. *Resources:* Board members, potential clients and constituents.
2. *Form a board of directors.* The initial board will help translate the ideas behind the organization into reality through planning and fundraising. As the organization matures, the nature and composition of its board will also change. *Resources:* BoardSource, planning and management consultant.
3. *File articles of incorporation.* Not all nonprofits are incorporated. For those that do wish to incorporate, the requirements for forming and operating a nonprofit corporation are governed by state law. *Resources:* State secretary of state or attorney general's office.
4. *Draft bylaws.* Bylaws—the operating rules for the board—should be drafted and approved by the board early in the organization's development. *Resources:* Attorney experienced in nonprofit law.
5. *Develop a strategic plan.* Strategic planning helps express a vision of the organization's potential. Outline the steps necessary to work toward that potential, and determine the staffing needed to implement the plan. Establish program and operational priorities for at least one year. *Resources:* Board members, planning and management consultant.
6. *Develop a budget and resource development plan.* Financial oversight and resource development (for example, fundraising, earned income, and membership) are critical board responsibilities. The resources needed to carry out the strategic plan must be described in a budget and financial plan. *Resources:* Fundraising consultant.
7. *Establish a recordkeeping system for the organization's official records.* Corporate documents, board meeting minutes, financial reports, and other official records must be preserved for the life of the organization. *Resources:* State secretary of state or attorney general's office.
8. *Establish an accounting system.* Responsible stewardship of the organization's finances requires the establishment of an accounting system that meets both current and anticipated needs. *Resources:* Bookkeeper experienced in nonprofit accounting.

9. *File for an Internal Revenue Service determination of federal tax-exempt status*. Nonprofit corporations with charitable, educational, scientific, religious, or cultural purposes have tax-exempt status under section 501(c)(3)—or sometimes section 501(c)(4)—of the Internal Revenue Code. To apply for recognition of tax-exempt status, obtain form 1023 (application) and publication 557 (detailed instructions) from the local Internal Revenue Service office or from the IRS Web site http://www.irs.gov/charities/index.html. Though it is not essential to consult an attorney when preparing this document, many organizations do seek the assistance of an attorney experienced in nonprofit law. *Resources:* Local IRS office, attorney.
10. *File for state and local tax exemptions*. In accordance with state, county, and municipal law, apply for exemption from income, sales, and property taxes. *Resources:* State, county, or municipal department of revenue.
11. *Meet the requirements of state, county, and municipal charitable solicitation laws*. Many states and local jurisdictions regulate organizations that solicit funds within that state, county, or city. Usually compliance involves obtaining a permit or license and then filing an annual report and financial statement. *Resources:* State attorney general's office, state department of commerce, state or local department of revenue, or county or municipal clerk's office.
12. *Other steps:*
    - Obtain an employer identification number (EIN) from the IRS.
    - Register with the state unemployment insurance bureau.
    - Apply for a nonprofit mailing permit from the U.S. Postal Service.
    - Obtain directors' and officers' liability insurance.

The Board of a Start-up Nonprofit

When setting up a nonprofit, the founder or founders form the first board for an organization. Start with a small but committed group that has the skills and expertise necessary to get started. Here are some suggestions:

- Include people who are familiar with constituents and their needs.
- Include people who have served on a nonprofit board or staff.
- If the organization depends on outside funding, engage someone who can help develop a fundraising plan.
- Find someone who understands the field or mission area.
- Include someone who is comfortable with technology.
- Bring in innovative people who have new ideas.
- Make sure all board members can work as a team.

Incorporation and Tax Exemption

Most nonprofits choose to organize themselves as corporations—a legal form of organization that is available to nonprofits under every state's laws. A corporation offers some desirable advantages, such as limited liability protection for its managers, directors, and officers. And, because of the relatively stable environment in which incorporated nonprofits function, business contractors and funders tend to prefer working with them. State statutes and common law govern the formation, organization, and ongoing operations of corporations.

Incorporation is not the same as applying for tax-exempt status. Through tax exemption, federal, state, and local governments provide an indirect subsidy to nonprofits and receive a direct benefit in return. Tax exemption is an acknowledgment of an organization performing an activity that relieves some burden that would otherwise fall to federal, state, or local government. Churches are automatically provided tax exemption as a safeguard to preserve separation of church and state by preventing governments from using taxation to favor one religion over another. Categories of tax-exempt organizations are described earlier in this chapter.

Articles of Incorporation

A corporation is a legal entity that exists in perpetuity until it is dissolved. It is a "fictitious person," separate from its managers or governors, and it is usually given many of the same rights and obligations as natural persons. A nonprofit corporation is able to conduct charitable, educational, or scientific activities; it can enter into contracts; it can incur debts; it can hire employees who are eligible for fringe benefits; and it is legally liable for its actions.

Nonprofit corporations are "created" by one or more incorporators—usually selected from among the initial board members—who sign and file the corporation's articles of incorporation with the appropriate state agency. The incorporators' role ends at that moment, and the board assumes the responsibility for the organization. Each state's law prescribes the content and form of this binding legal document. Articles of incorporation generally include the following:

- Name of the corporation
- The organization's specific purpose (this should be brief and broad to allow for future evolution, but should clearly indicate its tax-exempt focus)
- Duration of the corporation's existence (often perpetuity)
- Location of the organization's office

- Number, names, and addresses of the initial board of directors
- Whether or not it is a membership organization
- Provisions for distribution of assets when the corporation is dissolved

Amending the Articles of Incorporation

Articles of incorporation should remain as general as possible within the framework of state law. The bylaws provide further detail on the governance structure, and additional policies and procedures secure the rest of the necessary guidelines for effective and ethical functioning of the organization. Sometimes major changes in status, activities, or structure of the organization require the articles to be amended. These changes include

- Changing the organization's name or address
- Substantially changing the organization's mission
- Altering the provision for the disposition of assets if the organization is dissolved
- Changing the way board members are elected (formal membership structure or self-perpetuating board)

Special Types of Nonprofit Organizations

Not all nonprofit organizations are structured similarly with independent, self-perpetuating boards. Other types include a federated system with a national office and local chapters or formal membership organizations whose members are the main beneficiaries of the services and in return have a say in the internal affairs of the organization.

Federated Organizations

A federated organization is a national umbrella organization that has smaller chapters or affiliates with a regional or local reach. It typically is a membership organization whose members are the chapters, but it is possible to have individual members as well. Chapters may also be membership organizations with individual members, but they may function as separate and independent public charities.

The national organization typically acts as the spokesperson for the cause and sets the overall strategic vision for the federated structure. It also provides support

for the local chapters. The chapters provide mission-related programs or services to a local area. Examples of federated organizations include the American Lung Association, Boy Scouts of America, and Habitat for Humanity.

Formal Membership Organizations

Many nonprofits have members who might also be described as supporters, donors, or friends who believe in the mission of the organization. They receive benefits such as discounts, newsletters, and helpful information. This is a membership structure that has no legal implications, and it does not need to be defined in the organizational documents of the nonprofit. However, if members are granted a say in the structure and priorities of the organization, they are part of a "formal" membership organization, and their categorization and authority levels must be clarified in the articles of incorporation and in the bylaws. Formal members usually elect board members and officers, and they can approve amendments to the bylaws. A trade association usually is structured as a formal membership organization. Other examples of formal membership organizations include the United Way of America and the National Association of Social Workers.

Chapter Exercises

- Describe how nonprofits intersect with your daily life.
- What circumstances might influence the growth or shrinkage of the nonprofit sector?
- Define *public trust*, and discuss why it should be important for a tax-exempt organization.
- Discuss what a productive collaboration between a nonprofit, a for-profit, and the public sector might look like.
- If you wanted to establish a homeless shelter in your community, what are the decisions and choices you would have to make along the way?
- List the different ways nonprofit tax-exempt organizations can or should self-regulate.

CHAPTER TWO

WHAT IS GOVERNANCE?

Whatever its size, scope, or funding, every nonprofit organization has a governing board composed of people who believe in and support the mission. Board members have the pleasure—and the responsibility—of monitoring, overseeing, and providing direction for the organization's pursuit of that mission. Those responsibilities, which have legal ramifications, call on board members to develop or hone understanding in many areas, from financial management to organizational communication, from fundraising to strategic planning. Although it is impossible to calculate the precise number of people who are members of these governing boards at any given moment—nearly all of them without compensation—we do know that millions of women and men accept the fiduciary and other responsibilities of board service.

Governance Defined

Governance is the board's legal authority to exercise power and authority over an organization on behalf of the community it serves. The board is authorized to establish policies and make decisions that will affect the life and work of the organization. The board is where the proverbial "buck" stops; it is also held accountable for the actions that follow those policies and decisions. Governance is group action. Individual board members do not govern the organization. Rather, meeting as a group confers governing status to the board as a whole.

Authority to govern an organization may be granted by a variety of sources, from organizational members and supporters to public officials. When an organization is incorporated, the state in which the incorporation takes place assigns

responsibility for the organization's affairs to a governing board. An organization's articles of incorporation or constitution (see Chapter One) and its bylaws (see Chapter Fourteen) will specify how its board is to be constituted and organized.

Sometimes groups other than the board carry the authority to control certain board decisions. For instance, in some membership organizations, a representative house of delegates must approve bylaws changes. In subsidiaries, certain decisions may require the approval of the parent organization board or must conform to a policy framework established by the parent board. Examples of such decisions include election of board members, changes in bylaws, sale or acquisition of property, hiring of the chief executive, or choice of management service provider.

There are some similarities—but many differences—between corporate boards and nonprofit boards. Both for-profit and nonprofit organizations need strong board leadership and must adhere to certain legal principles that are outlined in state corporation laws. But for-profits answer primarily to their shareholders and focus on generating profits for those people. In contrast, nonprofits are accountable to their members, constituents, supporters, donors, and the public; their missions are not to make money but to make a difference in someone's life or the world.

This chapter reviews fundamental responsibilities and principles of governance: the board's fiduciary responsibilities, the difference between collective and individual responsibilities, the critical place of mission at the center of governance, and the guiding principles of effective governance.

Why Nonprofits Need Boards

There are legal, ethical, and practical reasons to build a board when a nonprofit is created. These reasons shape the foundation for good governance.

Legal Reasons

State laws require that nonprofit corporations have a board to assume the fiduciary role for the organization's well-being. These laws assign overall responsibility and liability to that board. In addition to the board's responsibilities as a governing body, individual board members are bound by their legal obligations: the duties of care, loyalty, and obedience (see "Collective and Shared Responsibilities," later in this chapter).

State laws generally stipulate the minimum size for a board—mostly between one and three members—and other requirements that define how boards may function or be structured. Some state laws define the smallest acceptable number of independent board members (that is, members without specific personal benefits or attachment), but usually the laws do not address board composition. The articles of incorporation and bylaws define the internal authority within the nonprofit and clarify the board's role on top of the decision-making hierarchy. (Naturally, in a formal membership organization the members have certain rights to approve major board decisions.)

Federal law is less specific about board structure, but it does expect the board to serve as the gatekeeper for the organization. When applying for recognition of tax-exempt status, board members for a nonprofit must be listed to allow the IRS to determine whether proper oversight has been established. In complying with federal law, one of the board's roles is to ensure that no inappropriate private inurement takes place—a situation when an insider with decision-making power misdirects organizational assets into the hands of individuals who don't provide commensurate products or services in return (see Chapter Seven, Legal and Ethical Responsibilities).

Ethical Reasons

The board functions, in part, to assure the public and all stakeholders that the organization is in good hands. It assumes responsibility for the organization's achievements or lack thereof. It goes beyond the legal requirements to ensure that the organization not only does things right, but does the right thing.

The board acts as the agent for the organization's constituents. When a supporter, client, or customer relies on the organization to use its funds appropriately or provide trustworthy and quality services, the board sees to it that these expectations are met. Board members are not there to benefit personally from their affiliation; during decision making they are expected to place the interests of the organization above any other considerations.

Oversight is a primary duty for all boards. They work closely with management to ensure that goals are met and that ethical principles guide all activities. As overseers, board members also spell out the expectations and evaluate the results. The board is there to go above and beyond the status quo, keeping the organization viable by reacting to and anticipating stakeholders' needs.

Practical Reasons

A board is made up of individuals who, at one time or another, dedicate their efforts to help the organization get its work done. Especially in start-up

organizations, boards draft the organizational documents, hunt for supplies and equipment, and procure funding. Before a staff is hired, board members usually manage the daily affairs and run the programs of an all-volunteer organization.

In most nonprofits, as soon as the situation allows, the board hires the first staff member—often a chief executive—and delegates the daily affairs to him or her, with the necessary support and guidance. At this point the board can devote its time to governing, providing direction, and ensuring that the mission of the organization stays on course.

Detached from daily affairs, the board is able to differentiate the trees from the forest—to look at the organization as part of its larger sphere and not just as an office that carries out the strategic plan. The perspectives that board members bring to the boardroom complement those of the chief executive. Together, they should be able to ask the probing questions necessary to avoid stagnation and keep the organization moving forward.

Finally, the board provides continuity. Individuals come and go, but the board as an entity remains. When good practices are institutionalized, the changing of the guard does not adversely affect the good work that has been accomplished.

Board Members as Fiduciaries

Contemporary law regarding the responsibilities of nonprofit board members is grounded in English common-law rules for administrators of charitable trusts. This framework assigned a great deal of responsibility to individual trustees and tended to foster a fairly cautious approach to organizational affairs. A number of court cases have since placed interpretation of nonprofit board accountability within the framework of corporate law. Now, legal responsibility in general rests with the board as a body rather than with individual board members. (For more about the legal responsibilities of nonprofit boards, see Chapter Seven.)

Board members today are fiduciaries of the organization's resources and guardians of its mission. Most state laws, by statute or court opinion, impose on board members the standards of conduct and management that, together, constitute fiduciary responsibility. Thus personal liability can result when a board member, officer, or key employee of a nonprofit organization breaches the standards of fiduciary responsibility.

A chief responsibility of board members is to maintain financial accountability and effective oversight of the organization they serve. As stewards of the