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# Essential Organizational Steps and Initial Nonprofit Documents

Prepared

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## **Essential Organizational Steps and Initial Nonprofit Documents**

### **I. Preliminary Considerations**

In creating a new not-for-profit corporation, the founders should evaluate several important issues that will affect the entity's organization and operation. The following questions address pre-incorporation issues that must be considered jointly by founders and legal counsel. In many cases, the answers to these questions may form the basis for an agreement similar to a pre-subscription agreement used when setting up a business corporation. In addition, persons who are managing an established nonprofit organization may use the following questions as a form of mini-audit. The answers to these questions will continue to relate to the effective operation of all such organizations.

#### **A. The Founders — Who Is Organizing the Organization?**

Founders are those people who see the need for a new organization and put personal effort into its development. Sometimes, there is only one founder who inspires others to join the effort. Founders have many tasks, such as obtaining financing, networking, developing the organization, business planning, dealing with regulatory issues, developing staff and resources, etc.

Organizational documents need to accurately define the delegation of authority and responsibility and the relationship between members, directors, officers, and other corporate agencies. If these matters are well planned at the beginning, the prospects for a successful not-for-profit organization are greatly enhanced.

#### **B. The Purposes — What Are the Goals of the Organization?**

Significant effort needs to be invested in thinking through and adopting the organization's purpose statement, since a well-drafted purpose statement is essential to the development of an effective not-for-profit organization. Such a purpose statement gives focus to all planning activities, defines the organization in the context of relevant law, and gives the participants the ability to concentrate their corporate efforts. Without a good and concise purpose statement, it is difficult to formulate and act on development plans.

The purpose statement serves four critical functions. First, it serves as the rallying point for interested persons to become motivated and to make commitments to the emerging organization. Second, it is a basis for determinations by the Secretary of State, the IRS, and all other government agencies deciding whether to issue necessary authorizations such as the corporate charter and letter of tax-exempt status. An inadequate or confusing purpose statement will obstruct or delay completion of these essential regulatory procedures. Third, the purpose statement makes a critical

first impression when the organization applies for funds from any foundation or governmental agency. Fourth, when competing ideas draw on the organization's financial and staff resources, the purpose statement will help the board and key leadership develop priorities.

The founders should evaluate the new organization's goals and purposes. A simple and concise statement of purpose, including specific reference to an approved statutory purpose, is a valuable asset as the initial board and staff establish programs and solicit resources from donors and other interested parties. In most cases, the purpose statement can (and should) be written in less than 50 words; it will still be a meaningful expression of the organization's essential goals.

Founders often begin with a wide range of ideas about corporate purposes. These must be sorted and aligned by a process of group consensus. The purpose statement should balance the need for specificity with the need for openness and breadth. The mere recitation of a statement that "corporate purposes will be those permitted by statute" is a superficial and ultimately problematic way to guide the new organization's development. On the other hand, an exhaustive statement of methods and processes to be used is unnecessary and may limit the organization's future development. Properly drafted, the statement of corporate purpose will serve the board just as a compass serves wilderness travelers — it will help keep everyone going in the same direction.

#### C. The Beneficiaries and Members — Who Will Benefit from the Organization's Activities?

Not-for-profits, both in Illinois and elsewhere, basically fall into two categories: those without members, such as charitable service organizations, schools, and agencies that tend to serve an indefinite population, and membership organizations that have a defined group of beneficiaries, such as churches, social clubs, and agencies that rely on the support of a specific committed constituency. It is important that the founders consider who will benefit from the organization's services.

The Illinois NFPCA does not require a not-for-profit corporation to have members, nor does it require that any member have a vote on any subject. If they exist, they should be there for a reason. Members have two potential purposes in a not-for-profit organization: they may be part of the organization's governance structure and/or they may be the organization's beneficiaries, or both. The issue of membership therefore must be considered in the context of leadership and the organization's purpose.

Organizations such as churches, social clubs, self-help groups, cultural institutions and societies, and trade associations are oriented to serving members. They exist because a group of founding members joined together to form an organization from which they expected to receive some form of benefit or service. They will have members performing governance activities, and their bylaws will reflect their presence in voting for the organization's board of directors. When forming a membership organization, care should be taken to define members' corporate authority, especially

what matters will be subjected to vote. The more authority reserved to the membership, the more cumbersome will be the corporate operations. The practitioner must balance the need for membership involvement and the credibility factor of an active membership with the potential for unwieldy procedures and corporate inertia.

If the not-for-profit corporation intends to be a Code §501(c)(3) entity, there must be strict limits placed on corporate members that are for-profit entities. The IRS will not permit a tax-exempt organization's purpose to include a profit motive. If for-profit members are allowed to participate, it is wise to develop membership classes that have maximum percentages of for-profit members or to use other methods to enforce control limitations.

An Illinois not-for-profit corporation may incorporate without voting members; most eleemosynary entities are hindered by having them. Such organizations are best off being governed by a self-perpetuating board of directors.

The IRS requires that charitable beneficiaries be identified, whether by age, sex, geographic location, income, disease, state of residence, religion, etc. While there may be no limits on what groups the organization may seek to benefit, founders must understand that there are many types of people and organizations that do not qualify as objects of charity under IRS regulations. The selection of inappropriate beneficiaries may disqualify the organization from being granted exempt status.

#### D. The Operational Plan — How Will the Organization's Purposes Be Achieved?

With a concise statement of purpose and a clear set of priorities as to what benefits the members and/or beneficiaries will be receiving, the founders can consider what operational plan will best accomplish their ends. The business community would describe this process as forming a business plan, and, like a business plan, the operational plan should help the founders make appropriate decisions about the need for services, funding, regulatory issues, etc. A good operational plan provides for programs and services and addresses staffing issues, finances, facilities and equipment, governance, and fund-raising. Starting a new organization without a complete operational plan will lead to confusion and frustration for the founders, as well as their targeted funding sources. Without a good operational plan, the organization may not obtain sufficient financial support, no matter how worthy its purpose or how needy its proposed beneficiaries.

When government regulation is involved, planning is an especially critical process. Any not-for-profit corporation that operates a school, medical and mental health facility, child welfare agency, and a program that involves food preparation, housing, education, and child care is regulated by various state agencies. If the organization requires a certificate of need, license to operate, or registration, the founders will not be able to commence operation until the operational plan has been fully reviewed and the appropriate certificate or license issued or registration effected.

Finally, a realistic and credible organizational plan is a necessary part of a Code §501(c)(3) exemption application. The plan must be carefully evaluated to determine if the organization will qualify for tax-exempt status and shaped if necessary to meet IRS requirements. A poorly developed plan will delay approval by weeks or even months. Sometimes, a poorly drafted application will lead to such a deadlock with the IRS that the corporation must be abandoned and a new one started in its place, with a new name and new federal employee identification number (FEIN), so that there can be a fresh start with the IRS on the exemption process.

#### E. The Resources — How Will the Organization Be Financed?

A vital aspect of every not-for-profit organization is its financial viability. Often the founders have ideas about establishing a much-needed service but no idea about how to finance its activities. Any not-for-profit organization that is unable to secure adequate funding will fail. Founders must work diligently at this aspect of the operational plan, so that they develop a budget that adequately addresses funds for incorporation expenses, nonrecurring capital investments and operational start-up costs, operational expenses, and cash-flow needs.

Membership organizations usually have an expectation that prospective members or participants will provide operating funds. For example, churches are financed by congregants, and social clubs and trade associations have membership dues. Before committing significant resources to incorporating such organizations, the founders should survey prospective members and determine the extent of membership interest and ability to financially support operations of the new entity.

Fund-raising for a nonmember charitable service organization is substantially different. Persons who fund the charity cannot personally benefit from its programs or services, and their motivation for giving funds is, typically, very personal and specific. In order to satisfy prospective donors that they are committed to its success, founders should be personally donating substantial resources of some sort (time, talent, or tithe). If founders rely on oral promises of financial support from targeted donors, they would do well to secure a written pledge of the donors' support after an initial operational plan has been presented to them. Financial support may become far less than expected, and the shortfall may require a revision of operational plans before more time and money are invested.

If the founders are not experienced in operating a not-for-profit organization, they may benefit from reading books on management or by taking seminars or classes on not-for-profit management, financial management, human resource management, or fund-raising techniques. Many business books written for the for-profit sector will be useful to not-for-profit leaders. Most metropolitan areas in Illinois have local organizations that provide technical assistance to not-for-profit fund-raisers and managers. The Donors Forum of Chicago ([www.donorsforum.org](http://www.donorsforum.org)) is a "foundation center library" that is a central library of resources for exempt organizations that solicit charitable grants from local, regional, or national foundations. Similar foundation center libraries are available elsewhere in Illinois.

Those who are unfamiliar with fund-raising may hire a professional fund-raising consultant to work with the founders before the new organization begins operations. If that person can bring focus to the organization's purpose and sharpen its plan so that it will be attractive to donors, the dollars spent for such a consultant will be a good investment.

#### F. Founders' Syndrome — How Will Succession Be Provided For?

A delicate issue that should be confronted during the initial meeting of founders is the matter of succession planning. The organization's founders must plan for their eventual replacement so that the organization will not be subjected to "founders' syndrome." While the syndrome is not well documented, it does have anecdotal support from those who work with many not-for-profit organizations. While the syndrome also affects for-profit organizations, most entrepreneurial activities necessarily revolve around an individual or group and tend to continue as long as the founder or group is able to compete effectively in the commercial world. Not-for-profit organizations, being perpetual public entities, will not be affected by founders' syndrome in quite the same way.

Briefly, founders' syndrome is a notion that a founder has the only vision for the organization and is, therefore, irreplaceable. As time passes, the person with this notion becomes almost impossible to disengage. Frequently, an organization with founders' syndrome has a leader who dominates the entity and lets nothing happen without his or her approval. In serious cases of this syndrome, no new idea or plan can be enacted unless it comes from the founder (directly or indirectly). Such a founder can and will strangle a valid organization in his or her maintenance of control. Qualified directors and employees either leave the organization when they run up against founders' syndrome, or they, themselves, become entrenched along with their leader. Seldom will a founder acknowledge the syndrome after he or she has become entrenched. In many cases, the organization will cease to function effectively and will be forced to go through a painful and often destructive transition. This syndrome can arise, equally, with a subsequent leader who stays around too long and accumulates too much control over the board of directors.

In the initial stages of incorporation, the potential for founders' syndrome cannot, always, be easily detected. However, some indicators exist. One is the presentation of all of the ideas by the founder while the remaining members remain silent. Another is a refusal by the founder to set term limits for directors. It is not uncommon for a founder to secure his or her own employment, by ensuring that the not-for-profit is organized around his or her personal skills or aptitudes. These arrangements limit an entity's ability to develop into a substantial organization.

#### G. The End Game — What Becomes of Assets upon Dissolution?

Founders rarely want to discuss contingency plans for dissolution. For that reason, most organizations simply defer to the standard language recommended in IRS Publication 557, Tax

Exempt Status for Your Organization. However, two things warrant a careful consideration of the dissolution issue during initial discussions. First, it will be easier to discuss the end game when there are no assets and leadership is free of conflicts. Second, there may be key supporters who will expect to control the disposition of remaining assets if the organization fails.

The issue of disposition of assets upon dissolution will often involve the existence of a special relationship with an outside organization that should benefit, if the new not-for-profit fails. For example, churches may be started with “seed money” from their denomination, and the denomination will require a transfer of assets to the denomination in the event of dissolution. Local trade associations and societies may be part of a national group that will support the new agency but will want its investment to be returned rather than used to benefit another organization.

If a founder wishes to name a specific beneficiary in the dissolution clause, care should be taken to account for two concerns. First, the named beneficiary must have a tax-exempt status equal or superior to that of the not-for-profit being organized. Second, the named beneficiary may itself disappear or otherwise become disqualified before the new organization dissolves.

## II. Organizational Documents

### A. Articles of Incorporation

Under Illinois law, the initial organizational document is the Articles of Incorporation. This document, when approved by the Secretary of State, is the corporate charter, giving legal existence to the new entity. Articles of incorporation are not difficult to prepare, but care should be exercised to complete them properly, since they become the cornerstone of the organization and are frequently asked for, to establish corporate legitimacy and credibility. In other words, the articles create a first impression on grant makers and government agents.

### B. Bylaws

The Illinois NFPCA requires that all not-for-profits shall have a set of bylaws. The statute is liberal in allowing flexibility on how bylaws are to be written and does not specify bylaw contents. Unless an organization’s directors develop and approve its bylaws, the statute serves as a default set of bylaws. If they neglect their responsibility to draft appropriate bylaws, it behooves the directors to know the statute. In resolving a conflict among directors or other parts of a corporation, Illinois courts will look, first, to an organization’s corporate charter and bylaws for guidance and, if they find none, then to the NFPCA.

Just as articles of incorporation are essential to establishing a not-for-profit’s corporate status, its bylaws are essential to its governance structure. The proper formation of an Illinois not-for-profit corporation begins with a careful evaluation of the planned organizational structure and a skillful drafting of bylaws. Bylaws are certain to be an important document in an organization’s

long-term success. Without a good set of bylaws, the directors, officers, members, committees, advisory boards, and other agents of the corporation may have inadequate understanding of how authority flows through the organization. Using the metaphor of the human body, if the board of directors is the brain and the officers are the mouth, arms, and legs, then the bylaws are the skeleton, providing order and coordination of the relationships of the parts of the body.

The founders should develop a proposed set of bylaws before the initial meeting of the board. There will never be a better time to order the organization's essential functions. Once the initial directors have met and approved bylaws, the corporate structure becomes more precise, relationships and procedures become set, and participants take on a sense of entitlement to the powers, rights, and authority. Too often, the founders, ill-advised by legal counsel or seeking to save a few dollars by doing it themselves, adopt a set of "boilerplate" bylaws that comes from a form book or from some other organization the founders happen to know about. It is problematic for a corporation to adopt bylaws that do not accurately reflect its true organizational structure. Leaders will naturally conduct corporate affairs in a manner that is natural to the group they lead, and boilerplate bylaws may be nonsupportive at best, or, at worst, openly antagonistic, to appropriate organizational structures and systems. When later disputes trigger power struggles within an organization's governing structure, poorly developed bylaws will worsen, rather than resolve them.

The complexity of a not-for-profit organization is limited only by the imagination of its founders and the practicality and skill of those who draft its bylaws. Their express language should describe the most important aspects of order and structure in the new organization.

#### C. First Minutes

It is essential that the new corporation have written minutes that reflect the initial critical steps of the organization, including the following: election of directors and officers; adoption of articles of incorporation and bylaws; and authorization to pay incorporation expenses, to seek tax exempt recognition from the IRS, and to retain professionals.

#### D. Other Corporate Documents

Depending on the circumstances, the new nonprofit organization may also need to file charitable registrations with state authorities, applications for sales tax exemption, fund-raising registrations, and real estate tax exemption applications.