



## Nonprofit Organizations: Is It Time to Update the Bylaws?

Together with the corporate charter on file with any nonprofit organization's home state, the bylaws comprise the nonprofit organization's key legal documents and a roadmap for how a particular organization will function. In particular, the nonprofit organization's bylaws regulate critical matters including, without limitation, the charitable purpose(s) of the organization, the size and function of the governing body as well as the election, terms and duties of the organization's directors and officers. A nonprofit organization's bylaws must also include language affirming requirements and prohibitions for nonprofit 501(c)(3) organizations as set forth by the Internal Revenue Service ("IRS"). As a nonprofit organization grows or modifies its purpose, its bylaws should be amended and updated to reflect the changes.

Bylaws must reflect the current business and decision-making structure of a nonprofit organization because, if action is taken outside the permissible scope of authority set forth in its bylaws, such action may be considered "ultra vires" and serious consequences may result. These ultra vires acts, literally "beyond power", are at risk

of being nullified. For example, any contract that is outside the bylaws' scope of permitted activity may be voided if challenged. Similarly, any director action that conflicts with the bylaws may result in such director or directors breaching fiduciary duties owed to the nonprofit organization (including, without limitation, the duties of care and obedience). Bylaws should, and usually do, contain language limiting director liability; however, by failing to fulfill fiduciary duties, a director may forfeit such protection and risk personal liability for any



harm caused. Importantly, neither D&O (director and officer) insurance purchased by a nonprofit organization nor any corporate indemnification provided for within an organization's governing documents will provide safe haven

for directors acting outside the scope of their authority. Lastly, if the directors (or group of directors) are ignoring the rights of the nonprofit organization by acting outside the scope of their authority, either the members of the organization or group of directors opposing such action may bring a derivative suit on the nonprofit organization's behalf.

In addition to corporate law consequences for ultra vires acts, a nonprofit organization may jeopardize its tax-exempt status if the organization does not comply with the purpose established in its bylaws. Pursuant to Section of 501(c)(3) of the Internal Revenue Code, a nonprofit organization must be organized and operated exclusively for exempt purposes (as enumerated in Section 501(c)(3)), and none of its earnings may inure to any private shareholder or individual. The IRS, upon a nonprofit organization's application for tax exemption, analyzes the organization's purpose and whether such purpose qualifies as an exempt purpose. Substantial changes to a nonprofit organization's character, purpose, or methods of operation that are inconsistent with its tax exemption, risk IRS revocation of the organization's tax-exempt status.

Nonprofit organizations outgrowing their bylaws or changing their purpose(s) should amend and update corporate documents to reflect their current circumstances and purposes. The first step is for a nonprofit organization to review existing bylaws to determine authority to revise and processes for facilitating such revisions. For any amendment or restatement of the bylaws to be a valid act, the nonprofit organization must be taken by properly authorized individuals and pursuant to prescribed bylaw procedures. If a nonprofit organization has an existing Bylaw Committee, or the authority to establish such a committee, such committee should contain members, directors and officers from a cross-section of the nonprofit organization to ensure proper representation of all organizational facets. Any proposed changes developed by the committee may be forwarded to the proper authority whether it is the nonprofit organization's members or directors. If such committee does not exist, then action should be taken by the members or directors, whoever has been empowered with the authority.

Bylaw changes must comply with the nonprofit corporation statute of the governing jurisdiction. The statute sets out the requirements for and prohibitions against nonprofit organizations and supersedes the bylaws if there are any contradictions. Also, when a 501(c)(3) organization changes its bylaws, the nonprofit organization must report those changes to the IRS on its Form 990. If a nonprofit organization has any concerns, it can submit bylaws proposed to be amended or a letter describing the anticipated changes to the IRS Exempt Organizations Determinations Office for guidance on whether the changes jeopardize its tax exemption.

Nonprofit organization bylaws should be drafted with built-in flexibility to address from time-to-time the changing circumstances of the nonprofit organization. Proper bylaws will ensure changes resulting in technical non-compliance will not trigger a required bylaw amendment, but, rather, will provide a flexible alternative. For example, the nonprofit organization should provide for a range of directors and specific organizational and

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decision-making details should be in director-approved policies rather than in the bylaws.

A nonprofit organization's bylaws must remain up to date with the organization's circumstances as well as compliant with applicable statutes (both state and federal). If you have any questions regarding forming a nonprofit organization, applying for 501(c)(3) tax-exempt status, or amending/restating an organization's bylaws you should consult a DarrowEverett LLP attorney.

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