A non-profit is an organization that serves the public interest. Its mission and operations are charitable, educational, scientific, religious or literary. A non-profit does not declare a profit but rather utilizes all revenue net of operating expenses. No part of the ownership or assets are assigned to benefit any one person or group of people.

Non-profits can be unincorporated or incorporated entities, partnerships, or cooperatives, although most non-profits are corporations. At a minimum, most states require a non-profit to have a board of directors, maintain a set of bylaws and hold an annual meeting.

The definitive factor in determining an organization’s non-profit status is its legal structure—whether or not it was legally formed as a non-profit organization.

**Tax Exempt Status**

The U.S. Tax Code section 501(c) exempts certain organizations from federal corporate income tax, qualifies the organization for discounts on postal rates and grants it access to government and private grants. In order to qualify for tax-exempt status, a non-profit organization must be incorporated, then complete an application along with Form 1023 (a 3-year projected budget for a start-up). If the organization is accepted, it will receive a Determination Letter from the IRS. Tax-exempt organizations are required to complete and submit an annual 990 tax form to the IRS, as opposed to the 1120 form required of non-tax-exempt non-profits and for-profit organizations.

**Classes of Non-Profit/Tax Exempt Business**

**Charitable organizations 501(c)(3)**
- Foundations
- Educational organizations
- Hospitals, clinics and healthcare organizations
- Literary organizations
- Museums
- Organizations to prevent cruelty to children or animals
- Organizations for public safety testing
- Religious organizations and churches
- Scientific organizations
- YMCAs, YWCAs, boys’ and girls’ clubs

**Trade and Professional Associations 501(c)(6)**
- Professional associations representing the building and trade industries
- Bar associations
- Professional associations representing the service industries
- Associations of sports professionals
- Chambers of commerce
- Business leagues

**Labor Organizations/Unions 501(c)(5)**
- Unions and collective bargaining associations

**Social Service Agencies/Social Welfare Organizations 501(c)(4)**
- Civic leagues
- Homeless shelters
- Legal aid organizations (can also be assigned to 501(c)(20))

**Social Clubs 501(c)(7)**
- Recreational clubs
- Golf and country clubs
- Dog club
- Yacht club

**Fraternal Beneficiary Societies 501(c)(8) or 501(c)(10)**
- Fraternities and sororities
- Fraternal orders of police

**Veterans Associations 501(c)(23)**

**Burial and Cemetery Associations 501(c)(13)**

**Non-Profit Cooperatives 501(c)(12)**
- Mutual rural water or irrigation companies
- Mutual cooperative telephone companies
- Mutual cooperative electric/power companies
- Miscellaneous cooperatives

**Non-Profit Financial Institutions**
- Credit unions—501(c)(14)
- Mutual insurance companies—501(c)(15)
The Corporate Structure of Non-Profits

The corporate structure of non-profit organizations is becoming increasingly complex. The need to find alternative sources of revenue and the constant push to respond to member needs are prompting many non-profits to diversify their services and create new entities. Whether or not these entities take on the structure of a subsidiary, partnership, affiliate or chapter depends on the purpose and the tax and legal implications of the venture. Some of the entities that non-profits may create include:

**Subsidiaries** - An entity in which the parent company owns greater than 50% of the voting shares of the entity.

**Partnerships** - An entity in which the parent company owns 50% or fewer of the voting shares of the entity.

**Non-Profit Subsidiaries** - An incorporated entity in which the parent company has control of the board and fiscal management and has the right to dissolve the organization.

**Affiliates** - A partnership in which the non-profit owns 50% or fewer of the voting shares or contributes equally to the financial investment, has board representation, and does not retain the sole right to dissolve the organization.

**Chapters** - An entity created or chartered by an international, national, regional or state organization that follows the same mission and usually identical bylaws. Chapters may or may not be incorporated and may have separate boards.

Questions You Should Ask About the Structure of Non-Profits

1. Do you have an organizational chart on which all your subsidiaries, affiliates and chapters are identified? This will assist in distinguishing between actual entities versus programs or activities.

2. Do the chapters, subsidiaries or affiliates have separate boards apart from the main entity?

3. Is the main entity separately incorporated?

4. Is the main entity a paper company or operating company?

Why are these questions important? Consider the following examples:

- A low income housing development corporation typically has a non-profit parent who sets up several paper companies to hold the individual properties for which they will receive HUD funding and create individual limited partnerships for the financial management of each property.

- AAA automobile club is a membership organization that provides travel information to its members; however the club also sells insurance and investment products through its for-profit subsidiary.

- A professional medical association can have an affiliated non-profit foundation, a for-profit subsidiary that publishes its medical journal, a for-profit subsidiary that markets insurance products and manages the group insurance trust, a political action committee (PAC), and a chapters in each state.

- A non-profit golf & country club can be owned by a for-profit parent company.

- A construction trade association could have a non-profit foundation, a non-profit subsidiary that manages a homeowners warranty fund, and a joint apprenticeship training fund in partnership with the union.

- A non-profit hospital could have a non-profit foundation, a for profit company that runs the ambulatory care, and a clinic in partnership with a doctor’s group.

The Insurance Contract

Generally, a non-profit D&O policy is intended to provide defense costs and indemnity coverage to the entity, its directors, officers, trustees, employees, volunteers and committee members for loss from lawsuits that allege internal mismanagement of the entity. It is not intended to provide coverage for loss from lawsuits that deal with the quality of professional services delivered.

Gray areas include:

- Services provided by staff attorneys

- Referral services or consulting services provided by an association

- Social services provided by volunteers

Who Is Covered?

In most cases, the definition of insured and any endorsements naming any additional insureds define who is covered under the policy. Generally, independent contractors, members, outside consultants, and other companies who enter into contract with the insured are not
The Underwriting Process

The Underwriter’s Perspective
To properly evaluate a risk, the underwriter needs to understand the structure, nature of operations and activities, the current financial condition and the loss history of an organization and its subsidiaries. At Schinnerer, our underwriters require:

- A complete application
- Two years of the most recent audited financial statements, Tax Form 990, internally prepared financial statements or annual report
- Loss history with the allegations, status, date reported and amounts paid in defense costs and indemnity or settlement
- A complete explanation of the nature of operations and activities and the web site address if applicable
- Samples of publications
- A copy of the employee handbook and any employment policies or procedures
- Bylaws and Articles of Incorporation
- List of the board of directors
- Organizational chart

The most common reasons an underwriter might decline a risk include loss history, financial condition or operations that fall outside of their defined underwriting guidelines.

What Is Covered?
The insuring clauses, definition of claim, definition of wrongful act and any additional coverage endorsements will outline what is intended to be covered under the contract. Excluded allegations are outlined in the exclusions section of the policy and in any additional exclusionary endorsements attached to the policy.

Most common D&O exclusions:
- Fraudulent and criminal acts
- Bodily injury and property damage
- Fiduciary liability
- Pending or prior litigation

Important Policy Issues to Review with a Policyholder
- Claims reporting requirements.
- Hammer clauses or settlement provisions.
- Retention and any coinsurance requirements
- Provisions relating to reporting of mergers and acquisitions
- Claims-made vs. occurrence policies. Your clients should understand that under a claims-made policy, claims must be made during the policy period to be covered
- Defense provisions. If the policy is a duty to defend policy, the insured may not retain counsel and handle the case without the insurer if they seek coverage under the policy.

The Exposures a Non-Profit Faces
In evaluating risks, underwriters also have to consider the kinds of exposures non-profits face.

Employment practices liability
- Wrongful termination
- Discrimination
- Negligent supervision
- Sexual harassment
- Intentional infliction of emotional distress

Evaluation of these exposures involves review of the number of employees and volunteers, the entity’s employment policies and procedures and the employee handbook. Underwriters also consider whether or not the entity has a human resources manager, whether or not there is training for managers and employees on the employment policies and procedures, whether or not there is a progressive discipline and grievance process, EPL loss history and trends of employment practices and claims for the particular class of business.

- Financial Mismanagement and Bankruptcy
- Breach of fiduciary duty
- Fraud

Coverage often depends on the capacity in which the defendant was acting when the alleged wrongful act was committed. Some carriers are unwilling to provide full coverage for the for-profit subsidiaries or partnerships.
Non-Profit D&O Risk Management

We’ve compiled a short-list of best practices. This is by no means a complete list, but rather a baseline for good risk management practices:

- Board members should participate in and document meetings.
- Non-profits should establish policies and procedures for employment issues, publishing and use of information and provide regular training to staff and managers.
- When faced with threat of litigation, or a situation that may lead to litigation, a non-profit should consult experts like attorneys, human resources consultants and claims experts.
- A non-profit should establish financial oversight committees and conduct frequent audits. It’s a good idea to engage a CPA to conduct a full annual audit and a review of internal controls.
- Non-profits should take advantage of the growing number of resources available to assist them with corporate governance and risk management issues.

Resources for Non-Profits

Non-Profit Risk Management Center
http://www.nonprofitrisk.org
1001 Connecticut Avenue, NW, Suite 410
Washington, D.C. 20036-5504
(202) 785-3891

The Center for Association Leadership
http://www.centeronline.org
Ronald Reagan Building
1300 Pennsylvania Avenue
Washington, D.C. 20004
(202) 326-9550

San Antonio Society of Association Executives
http://www.sasae.org
P.O. Box 780785
San Antonio, TX 78278
(210) 408-1699

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