

# Elements of Governance®

*Providing CEOs, board chairs, directors, and support staff with the fundamentals of healthcare governance*

A SERIES BY THE GOVERNANCE INSTITUTE

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## Articles, Bylaws, & Policies: Deciding What Goes Where

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# Elements of Governance®

A SERIES BY THE GOVERNANCE INSTITUTE

*Elements of Governance*® is designed to provide CEOs, board chairs, directors, and support staff with the fundamentals of not-for-profit governance. These comprehensive and concise governance guides offer quick answers, guidelines, and templates that can be adapted to meet your board's individual needs. Whether you are a new or experienced leader, the *Elements of Governance*® series will help supply you and your board with a solid foundation for quality board work.

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# Introduction

**A**n important element of corporate responsibility for the not-for-profit corporation board is memorializing in writing basic organizational and operational principles. Typically, three venues are available to do so:

1. Articles of incorporation
2. Bylaws
3. Board governance policies and guidelines

However, the question often arises as to the differences between these three venues and their appropriate, respective, content (i.e., “what goes where?”). In some situations, specific language is required by law to be included in a particular venue. In other situations, the board has flexibility as to the venue in which the language may be located. In still other situations, some or all of the language may be incorporated in more than one venue.

To provide not-for-profit governing boards with guidance on this important topic, this *Elements of Governance*<sup>®</sup> will address:

- The fundamental definition, function, and nature of these three venues: articles of incorporation, bylaws/code of regulations, and board governance policies
- The principle distinctions between articles of incorporation, bylaws/code of regulations, and governance policies
- Specific provisions appropriate for inclusion in articles of incorporation, bylaws/code of conduct regulations, and governance policies, respectively
- Provisions mandated by law for inclusion in the articles of incorporation
- Sample language

The hope is that by this discussion, board members, their executive leadership, and corporate counsel will have a better understanding of the appropriate role that each of the articles of incorporation, bylaws, and governance policies play in the context of corporate responsibility, legal compliance, and good governance.<sup>1</sup>

<sup>1</sup> Other forms of healthcare companies (e.g., hospitals, healthcare system parent companies, joint operating companies, other providers) can also be created as different types of legal entities depending upon state law (e.g., for-profit corporation; limited liability company; benefit company; religious corporation).

# Part I: Articles of Incorporation

## Nature and Function

The principal organizational document of the not-for-profit corporation is the “Articles of Incorporation.” Its framework is available in most states in a preprinted form through the secretary of state. The Articles of Incorporation, once approved and certified by the secretary of state, serves as the corporate charter; gives legal existence to the entity, and provides for its governance and management. ***As such, it serves as the written instrument by which the corporation is created under state law.*** Importantly, the Articles are maintained in the secretary of state’s files as a publicly available document. In this regard, the Articles often serve to provide a “first impression” of the corporation’s legitimacy to government regulators, potential donors, and grant-making organizations.

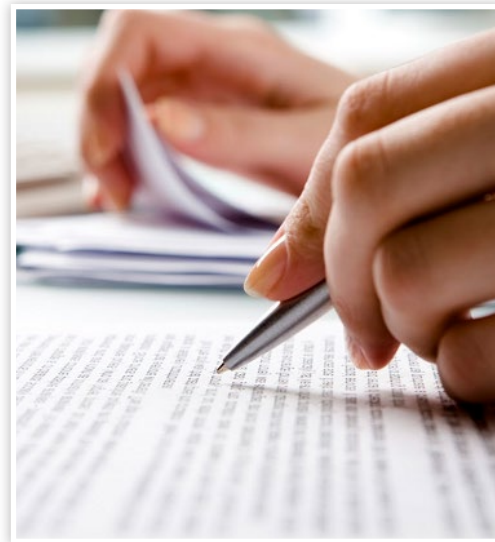


**Practice Note:** Remember that whatever language is included within the Articles will be available for public review.

## Basic Content

The Articles of Incorporation is in most instances a relatively short document. Depending on state law and practice, the information most commonly required by statute to be included within the Articles may include:

- The name of the corporation.
- The address of the corporation’s registered agent, for purpose of receiving official correspondence from the secretary of state and for receiving service of process in all legal actions.
- The initial board of directors of the corporation.
- The purpose for which the corporation is organized—this should be based on the variety of corporate purposes permitted under the non-profit corporations code of the particular state of jurisdiction (e.g., the Illinois General Not-for-Profit Corporation Act recognizes 30 qualified not-for-profit purposes in Illinois). These are corporate purposes that have been determined by state legislature to enhance the well-being of the general public (or a significant portion thereof).
- A statement as to whether the corporation is charitable or non-charitable.
- The county of location of the corporation’s headquarters.
- The duration of the corporation (if not perpetual).





**Practice Note:** *The statement of corporate purposes of a non-profit corporation is of continuous, crucial significance to the organization's legal standing and operational flexibility. It should be broad enough to encompass the full scope of the corporation's actual and intended purposes, to avoid concerns that it is operating outside of its stated purposes. Limitations of purpose grounded in geography or focus on a particular constituency should be avoided where possible. Health systems should consider adopting common or unified purposes to avoid intra-system corporate conflict on activities or direction.*

*Leading statements of governance principle recommend that the board periodically review the statement of purposes to assure that corporate operations are consistent with the articulated purposes (and if not, why not).*

## Optional Provisions

In most states, the Articles of Incorporation form allows the filing corporation to include such other information as it may select. This may include provisions with respect to (a) corporate or individual membership (if any); (b) the general management and regulation of corporate affairs; (c) defining, limiting, and regulating the rights, powers, and duties of corporate officers and directors; (d) quorum requirements; (e) the date of the annual meeting; and (f) other similar provisions (including provisions required by other statutes or by other regulatory agencies such as the IRS). Most organizations use this opportunity to incorporate provisions intended to assist it in qualifying for (and maintaining) tax-exempt status from the IRS.



**Practice Note:** *Consider whether it makes sense to include within the Articles language (for sake of duplication, clarity, or other reason) that which is also contained in the bylaws.*

## Special IRS Requirements

For not-for-profit corporations seeking classification pursuant to Section 501(c)(3) of the Internal Revenue Code, the Articles of Incorporation must contain certain additional language relating to the purposes and powers of the corporation and disposition of its assets upon dissolution. This required language is intended to satisfy the core exemption requirements concerning the manner in which the corporation is to be organized (the "Organizational Test") and operated (the "Operational Test").



To satisfy the *Organizational Test*, the Articles of Incorporation must limit the organization's purposes to those described in Sec. 501(c)(3): charitable, religious, educational, scientific, literacy, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty of children or animals. The Articles must not also expressly empower the corporation to engage (other than as an insubstantial part of its activities), in activities that do not further these purposes.



**Practice Note:** *The purposes articulated in Section 501(c)(3) of the Internal Revenue Code are separate and distinct from the list of appropriate purposes for an NFP corporation typically set forth in the state NFP corporation code. This is consistent with the basic tenet that a corporation elects to be organized for not-for-profit purposes as a matter of state law, and to be recognized as exempt from federal income tax as a matter of the Internal Revenue Code.*

The Articles of Incorporation must also acknowledge that the corporate assets will be irrevocably dedicated for an IRC Sec. 501(c)(3) purpose. This acknowledgment must also extend to future dissolution of the corporation; i.e., that upon any future dissolution of the corporation the assets will be distributed for a similar Sec. 501(c)(3)-recognized purpose, to the federal government, or to a state or local government for a public purpose. If the assets could be distributed otherwise (e.g., to members, private individuals, or any other purpose), the Organizational Test will not be met. In addition, if the corporation's intention is to designate a specific Sec. 501(c)(3) entity as the recipient of its net assets upon dissolution, the Articles of Incorporation must so provide, and must also identify an acceptable alternative distribution if the designated recipient is not an IRC Sec. 501(c)(3) charity at the time of dissolution.



**Practice Note:** *The Organizational Test won't be satisfied if the limit on purposes and activities is contained only in the bylaws or in board policies, or in statements by corporate officers. Neither will it be satisfied simply by the fact that actual operations are, indeed, for exempt purposes.*

To satisfy the *Operational Test*, the Articles must prevent the corporation from engaging (other than as an insubstantial part of its activities) in activities that do not further one or more of those stated Sec. 501(c)(3) purposes. This requirement encompasses the following:

- **Legislative Activity:** A non-profit corporation will not be eligible to qualify for IRC Sec. 501(c)(3) status if a substantial part of its activities constitutes an attempt to influence legislation. Accordingly, the Articles of Incorporation should contain a confirmation that no more than an insubstantial amount of its activities will indeed constitute legislative activities.
- **Political Campaign Interventions:** Organizations seeking IRC Sec. 501(c)(3) status are prohibited from participating in certain kinds of political activity. For example, such organizations are absolutely prohibited from directly or indirectly participating or intervening in any political campaign on behalf of (or in opposition to) any candidate for elective political office. Similarly prohibited are voter education or registration activities that (a) favor one candidate over another; (b) oppose a candidate in some manner; or (c) favor a group of candidates. Accordingly, the Articles of Incorporation should contain a confirmation that the corporation will not engage in prohibited political campaign interventions.





**Practice Note:** *The board should not consider these provisions as mere “boilerplate.” The Internal Revenue is increasingly sensitive to inappropriate participation by tax-exempt organizations in attempts to influence legislation or to intervene in political campaigns.*

*Accordingly, it is a good practice for the board to request its counsel to confirm that the bylaws contain language expressly satisfying these Operational Test requirements.*

- **Private Inurement:** The Articles of Incorporation should contain an acknowledgment that the corporation will not violate the prohibition against private inurement by Section 501(c)(3) organizations. This prohibition provides that, in order to qualify for exemption, no part of the corporation’s earnings may inure in whole or in part to the benefit of private individuals or shareholders.



**Practice Note:** *For specific wording, please refer to the link to the IRS template articles of incorporation set forth at the Appendix. “Freelancing” with these Operational Test requirements isn’t a good idea. To avoid problems with the IRS, it makes sense to simply parrot the IRS’ “template” language on a “word-for-word” basis.*

# Part II: Corporate Bylaws

## Nature and Function

The basic purpose of bylaws is to establish detailed internal rules for the governance and operation of the corporation. As such, bylaws represent the code or codes of rules (other than the Articles of Incorporation) adopted by the board to regulate, govern, and control the actions and internal affairs of the not-for-profit corporation. They are often regarded as permanent and continuing rules of conduct and action, and are thus forward-looking in nature. To that extent, bylaws supplement the Articles of Incorporation by memorializing organizational and governance details that are not required by law to be included in publicly filed documents. As a general rule, bylaws must be obeyed by the corporation, its directors, officers, and members. (Depending upon state law, a corporation's violation of its bylaws may be challenged by a director or member.)

While most state laws require that a not-for-profit corporation adopt bylaws, these laws typically do not proscribe specific contents or style for the bylaws. Rather,



state laws allow bylaws to contain any provisions deemed by the board of directors to be necessary for the management and regulation of corporate affairs. The only limitation on the contents of bylaws is that they may not contain terms or provisions that are inconsistent with either law or the Articles of Incorporation. Similarly, bylaws cannot place any restriction on corporate directors; any such restriction must be contained in the Articles in order to be effective. Furthermore, amendments to bylaws may be undertaken at will by the board, while amendments to the articles of incorporation

require filing with, and approval of, the secretary of state.

Unlike with the Articles of Incorporation, federal tax law does not require that specific terms and conditions be incorporated in the bylaws as a prerequisite for obtaining and maintaining tax-exempt status.

Specific bylaw provisions must: (i) be consistent with applicable law; (ii) not disturb any vested contract right; (iii) be nondiscriminatory in its application; and (iv) be subject to a basic standard of reasonableness in order to be enforceable under state law. The concept of reasonableness extends not only to the specific language of the bylaw provision but also to the practical manner in which the provision is applied. Courts will evaluate the reasonableness of bylaws under the particular circumstances (as a question of fact).



**Practice Note:** *The “reasonableness” of individual bylaw provisions (specifically those that may be controversial in nature) is often overlooked by the board. Courts will not enforce such provisions determined to be arbitrary or discriminatory in nature.*

Bylaws are adopted pursuant to statutory authority. However, because they are self-imposed, bylaws have no “public law” status; they are not required to be filed with the secretary of state or similar state official. Use of the term “bylaws” is not universally accepted; some states use the term “regulations” or “code of regulations” to describe these rules adopted by the board for its own self-governance.



**Practice Note:** *The provisions of the bylaws must be consistent with the articles of incorporation, and any bylaw provision inconsistent with the articles is not enforceable.*

## Typical Provisions

As noted above, bylaws are essentially a self-imposed set of rules for corporate conduct, and there are no specific statutory requirements for their conduct. Bylaws play a supplemental role to the articles of incorporation, inserting into the articles’ fundamental framework details that are not sufficiently important to be filed as a matter of public record. The not-for-profit corporation laws of most states do not specify bylaw contents and are flexible in terms of such content. Typically, however, the bylaws of a non-profit corporation track the provisions of state non-profit corporation law in terms of subject matter content. Accordingly, provisions usually found in the bylaws of a non-profit corporation include those addressing the following general topics:



- **The membership of the corporation:** e.g., whether the organization has members (individual or corporate), the rights of such members, and whether they are voting or non-voting in nature or established in classes.
- **The board of directors of the corporation:** e.g., general powers and duties; number, election, and term of office; resignations; vacancies; meetings (annual, regular, and special); notice of meetings; quorum; participation at meetings by conference telephone; informal action; and removal.
- **The officers of the corporation:** e.g., designation, election, and term of office; titles and duties (chair, vice chair, president, vice president, secretary, treasurer, assistant secretary, assistant treasurer, general counsel); resignation; removal; and vacancies.
- **Committees of the board of directors:** e.g., identification (standing or special); rights, powers, and manner of acting; selection of committee members; quorum; participation at meetings by conference telephone; meeting schedules; informal action; and the appointment other bodies.

- **Ethics and conflicts of interest:** e.g., statement of basic board policies regarding code of ethics and conflicts of interest.
- **Indemnification of directors and officers:** e.g., the right to indemnification; the right of a claimant to initiate litigation; non-exclusivity of rights; insurance; expenses as a witness; limitations on indemnification; and effect of amendment.
- **Miscellaneous provisions:** e.g., principal office; corporate seal; depositories; checks, drafts, notes, etc.; fiscal year; and delivery of notice.
- **Amendments to the bylaws:** the method of effecting an amendment to the bylaws.



**Practice Note:** *Precision in drafting bylaws is paramount; ambiguity can prompt significant interpretation issues that may, depending upon the materiality of the issue, ultimately require judicial resolution at considerable expense to the non-profit corporation. The intent of the governing board with respect to a particular bylaw provision should be plain and unambiguous.*

# Part III: Board Policies and Procedures

## Nature and Function

Governance policies and procedures are typically adopted by means of a resolution approved by the board. As such, governance policies are considered a more informal manifestation of limited nature addressing resolution of certain administrative matters of the corporation. This is in contrast to bylaws, which are the formal rules adopted by the board to regulate the conduct of the corporation and its members. Of course, governance policies are but one of many different actions manifested by resolution of the governing board. Yet, they are of increasing importance and significance in the “corporate responsibility” environment in which commerce finds itself, particularly given policy and regulatory focus on governance and “best practices” (see below).

The fundamental difference between governance policies and corporate bylaws is one of scope. Bylaws are rules adopted for the operation of the corporation as a whole, while a governance policy typically applies to a single act or affair of the corporation, or to some specific person, situation, or occasion. However, that distinction is not legally precise, and often times the decision of what governance controls are appropriate for inclusion in the bylaws, as opposed to adoption as board “policy,” may be more a factor of whether the topic, detail, and length of the proposed language is inappropriate or awkward.



For example, bylaws are often distinguished from resolutions in that they sometimes are subject to higher standards or greater formality in their enactment or amendment (e.g., supermajority requirement for amendment of articles or bylaws, as opposed to simple majority for approval of a resolution), but this is not always the case. The corporation may, if it so chooses, determine that a policy adopted by resolution has the same effect as the bylaws. Indeed, there may also be overlap between topics addressed in the bylaws and those addressed by governance policies. For example:

- The bylaws may contain a general statement regarding conflicts of interest and dualities of interest, yet the board adopts governance policies addressing conflict-of-interest management in great detail.
- The bylaws are likely to identify the standing committees of the board of directors, but the specific charters of those committees are often adopted by resolution, as governance practices.
- The bylaws typically address the constitution of the governing board, but the independence standards applicable to board membership and the expected qualifications of board members are usually incorporated into governance policies adopted by board resolution.
- The bylaws will normally authorize the board to invest corporate assets in a manner consistent with applicable law, but specific investment management guidelines are usually a function of board or committee policy.

- The board of directors is obligated to maintain in force a compliance plan designed to address the legal profile of the corporation, and the bylaws typically speak to the appointment of a chief compliance officer and a standing corporate compliance committee, as well as the adoption of a corporate code of ethics (and, possibly, of a code of ethics for financial officers). However, the specific corporate compliance plan and, often, the individual code of ethics are typically adopted as governance policies.

## Typical Provisions

The governance topics often covered by board or organizational policy and procedure are those either mandated or highly recommended by law, regulation, or public policy. In this regard, prime examples include governance policies required or prompted by the IRS, case law, and best practices compilations:

While there is no prescribed “list” of topics that should be, or normally are, addressed in governance policies, helpful guidance is provided from several particular sources:

- *First*, a substantial portion of the IRS’ new governance initiative for exempt organizations focuses on the promulgation of certain specific governance policies.
- *Second*, the Independent Sector has published the [Principles for Good Governance and Ethical Practice](#), which it recommends for consideration by all non-profit organizations. They include 33 practice recommendations relating to legal compliance, public disclosures, effective governance, financial oversight and responsible fundraising. Many of the governance policies and practices recommended by these sources are more suited for enactment by resolution as a board policy, rather than as a bylaw provision. Some of the recommendations are less well suited for adoption by large not-for-profit organizations. (See sidebar: Public Policy: Panel on the Nonprofit Sector for more information.)
- *Third*, recognized statements of governance principles from sources such as the [Commonsense Principles](#), the [Business Roundtable](#), the [Conference Board](#), and the American Bar Association contain many provisions of relevance to not-for-profit corporations, which can be suitable for board policy.
- *Fourth*, governmental compliance guidelines such as the [Evaluation of Corporate Compliance Programs](#) (published by the U.S. Department of Justice Criminal Division) contain many suggestions for governance-related policies and procedures.

## Internal Revenue Service

The IRS' strongly held view is that a well-governed not-for-profit organization is more likely to be compliant with applicable tax and other laws. Paramount in that regard is the presence of a clearly articulated (written) statement of purposes that describe the corporate mission (see above discussion of "Organizational Test"). Of similar importance, however, is a "thoughtful approach" to governance practices that, while not required by law, may enhance sound operation and improve tax compliance. These might include policies or procedures relating to management structures, operational policies, or administrative practices. The IRS' concern is, in part, that the absence of such policies and procedures could increase the risk of excess benefit transactions, operation for non-exempt purposes, or other activities that are inconsistent with the organization's charitable purposes.

Specific topics recommended by the IRS for consideration as governance policies and procedures include the following:

- The charitable *mission* of the organization
- The composition and size of the governing board, and the independence of individual board members
- The process by which executive compensation for the organization is determined
- The process by which the board addresses issues associated with conflicts of interest
- Board investment management practices
- Costs and practices associated with charitable solicitation
- The manner by which board and committee meetings are contemporaneously documented
- Standards for document integrity, retention, and destruction
- An organizational code of ethics that communicates a culture of legal compliance and ethical integrity
- The manner by which the organization handles employee complaints and allows employees to report in confidence any suspected misappropriation of charitable assets

## Case Law

Several prominent judicial decisions generally applicable to all corporations provide that the governing board has a fiduciary duty to implement and supervise a corporate compliance plan. These decisions are supplemented by related obligations imposed on boards by the Federal Sentencing Guidelines, as amended, and for healthcare providers, by the Department of Health and Human Services and the Department of Justice. Thus, the corporate compliance plan is so closely associated with the exercise of fiduciary duty that in essence it could be perceived as a board (as opposed to organizational) policy.

## State Charity Officials

The charity officials (e.g., charitable trust division of the state attorney general's office) in many states publish guidance to those considering the formation and operation, or seeking advice in connected with the governance responsibilities of officers and directors, of not-for-profit corporations. The New York State Attorney General, for example, publishes separate documents providing guidance on (i) forming and changing New York not-for-profit corporations; (ii) the responsibilities of New York

not-for-profit directors; and (iii) audit committee requirements and responsibilities under New York's not-for-profit corporation law.

Such state charity official guidance can be a useful resource to the governance and other committees of a not-for-profit healthcare organization board of directors.

### Public Policy: Panel on the Nonprofit Sector

On October 18, 2007, in a significant corporate governance development, the influential Panel on the Nonprofit Sector released the publication, *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* ("Principles"). In the Principles document, the Panel presents 33 concepts of "sound practice" recommended for consideration by every non-profit, charitable organization as a guide for strengthening its effectiveness and accountability. The Principles are particularly worthy of note by non-profit corporate leadership because they (a) address concepts beyond those that emerged in the wake of Sarbanes-Oxley (i.e., they are "second generation" in nature); and (b) are emerging during a period of unprecedented legislative, regulatory, and media focus on the corporate governance of non-profits.

If adopted, many of these principles would be reflected in governance policies approved by board resolution, rather than in bylaws.

"Best practices" and similar governance principles are aspirational goals and do not have the force of law. A board's failure to pursue best practices does not necessarily constitute breach of fiduciary duty. However, the consideration and adoption of such principles of good governance are likely to be considered by courts and regulators as evidence of the board's exercise of good faith, and thus can serve an important prophylactic role whenever board conduct is in question.

Of the 33 principles, six describe actions that all charitable organizations must take pursuant to applicable law. The remaining 27 principles describe actions that such organizations should strongly consider adopting, based upon their organizational and operational structure and charitable mission. In particular, the 33 individual principles are organized under four main categories:

- **Legal compliance and public disclosure:** responsibilities and practices intended to assist charitable organizations with legal compliance and in effecting transparency with the public
- **Effective governance:** policies and procedures to be adopted by boards in order to support oversight obligations and enhance efficient governance
- **Strong financial oversight:** policies and procedures designed to support the prudent oversight of charitable assets
- **Responsible fundraising:** policies and procedures recommended as a means by which non-profit organizations may develop donor support and confidence in their charitable solicitation activities

In so doing, the Principles suggest consideration of a governance framework for charitable organizations that goes beyond compliance with basic Sarbanes-Oxley concepts. This is particularly the case with respect to specific recommendations relating to board structure, independence, financial oversight, constituent transparency, and oversight of charitable solicitation activities.



# Conclusion

**T**he governing board should be aware of the three separate legal venues that exist and on which organizational and operational principles of the non-profit organization are based: articles of incorporation, bylaws, and corporate/governance policies and procedures adopted by board resolution. It is useful for boards and executive leaders to be familiar with the specific distinctions between these three venues and the content they support.

# Appendix: Online Drafting Resources

Sample Articles of Incorporation with Internal Revenue Service organizational language (from, *Life Cycle of a Public Charity-Sample Organizing Documents Public Charity-Draft A-Charter*): [www.irs.gov/charities-non-profits/charitable-organizations/life-cycle-of-a-public-charity-sample-organizing-documents-draft-a-charter](http://www.irs.gov/charities-non-profits/charitable-organizations/life-cycle-of-a-public-charity-sample-organizing-documents-draft-a-charter)

Governance-related questions from the IRS Form 990, “Return of Organization Exempt from Income Tax,” Part VI: [www.irs.gov/pub/irs-tege/f990rcore.pdf](http://www.irs.gov/pub/irs-tege/f990rcore.pdf)

Panel on the Nonprofit Sector, *Principles for Good Governance and Ethical Practice*: <https://independentsector.org/programs/principles-for-good-governance-and-ethical-practice/>

Illinois Secretary of State Jesse White, *A Guide to Organizing Not-for-Profit Corporations*: [www.cyberdriveillinois.com/publications/pdf\\_publications/c165.pdf](http://www.cyberdriveillinois.com/publications/pdf_publications/c165.pdf)

Form NFP 102.10—Articles of Incorporation, Illinois Not-for-Profit Corporation: [www.cyberdriveillinois.com/publications/pdf\\_publications/nfp10210.pdf](http://www.cyberdriveillinois.com/publications/pdf_publications/nfp10210.pdf)

The Business Roundtable Principles of Corporate Governance 2016  
<https://s3.amazonaws.com/brt.org/Principles-of-Corporate-Governance-2016.pdf>

Commonsense Principles of Corporate Governance 2.0:  
[www.governanceprinciples.org/wp-content/uploads/2018/10/CommonsensePrinciples2.0.pdf](http://www.governanceprinciples.org/wp-content/uploads/2018/10/CommonsensePrinciples2.0.pdf)

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4. 18A Am. Jur. 2d Corporations § 258-277.
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