



To: Jocelyn Bruce, President
Al Pina, Chair, FMCRC

From: Nydia Menendez, Esq. 

Re: Proposed Organizational Structure for NANAY

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FACTS:

An established 501(c)(3) corporation (NANAY, Inc.) owns a building valued at \$3.5M (est). This 501(c)(3) also provides social services to elders.

A related, but separate 501(c)(3) (NANAY Community Economic Development Corporation, or "NANAY CEDC") provides Homebuyer education, financial and foreclosure counseling. All grants and development projects are with the CEDC.

The companies wish to incorporate a for profit entity, so that the income stream from the for profit entity can be used, in part, to fund the activities and programs of the non-profit companies.

QUESTIONS:

1. What choice of legal entity should the non-profit incorporate?
2. Under which of the non-profit entities should the for-profit entity be incorporated?
3. What should be the relation/affiliation between the entities?
4. What are the tax implications, and the asset protection/liability insulation implications of having a for profit?

DISCUSSION:

For *asset protection* purposes we want to isolate/separate the assets from the activities that could give rise to any claims or liability. Hence, we should house the assets (in this case the building) in a separate entity (NANAY, Inc.). Additionally, we want to ensure that "dangerous/risky" activities do not create

any additional exposure that could taint or spread over all the assets. Therefore, we will also want to separate and isolate “dangerous/risky” activities into separate legal entities.

It is important to understand that there are always inherent risks with most operations and activities. For purposes of illustration, note some of the risks with the following activities:

- Providing social services to the elderly has risks. (E.g., A Senior slips and falls causing a hip fracture).
- Purchasing and selling real estate for profit (represented in LLC1, in diagram below) is an activity that has inherent risks. For example, acts of God (e.g., hurricanes), vandalism, Chinese dry wall, etc.
- Owning, renting and managing housing for low income residents (represented in LLC2, in diagram below) is also risky (e.g., non-payment of rent, failure to secure grants, injury claims, etc.) and could create exposure and liability.

Hence, the idea is to separate and isolate the distinct activities, and to also separate the dangerous/risky activities from the assets. Then, if there is a claim arising from LLC1 (the purchasing and selling of real estate), no claims or liability should attach to the assets of LLC 2, or against the main asset – the building – which is held by a completely separate legal entity, NANAY, Inc. In other words, the corporate structure we implement should ensure that the inherent risks from any activity remains within the confines of the legal entity in which the activity is conducted, and that the assets of any affiliated entity are insulated from outside claims.

Then, for purposes of *simplicity and cost effectiveness*, especially with return preparation, the favored entity for the for-profit ventures would be limited liability companies (“LLC”). With an LLC the advantage is that for tax preparation/filing purposes the LLC would be treated as a disregarded entity, meaning that it would be considered a “division” of the 501(c)(3), therefore not requiring a separate tax return. Yet, the LLCs would allow the vetted limited liability(provided all corporate formalities are observed).¹

As alluded, it is critical that all the legal entities respect the corporate formalities. Below we list some of the most critical corporate formalities that should always be observed.

¹ For the current purposes, we propose to have single member LLCs, with the sole member being NANAY CEDC. We note that another layer of asset protection would apply if the for profit LLC had more than one member. However, multiple member LLCs would require additional tax returns, thus eroding some of the simplicity and cost efficiency we are seeking.

RECOMMENDATIONS FOR NANAY:

Having explained the benefits of asset protection and the reduction of administrative burden and expense resulting from additional tax returns, the recommended set-up for NANAY is to use the already existing 501(c)(3) corporation that owns the building (NANAY, Inc.) only for that purpose. NANAY, Inc. would then act as the Landlord for NANAY CEDC and the soon to be incorporated for profit limited liability company, NANAY Community Enterprises, LLC (“NANAY Enterprises”). Further, NANAY, Inc. should not undertake any additional “risky” activity. By separating “risky/dangerous” activities from the legal entity that holds NANAY’s largest and most valuable asset, namely the building, we can achieve the greatest protection from claims that may arise as a result of those activities.² This structure would effectively put the property/assets out-of-reach of any creditor's unfunded liability.

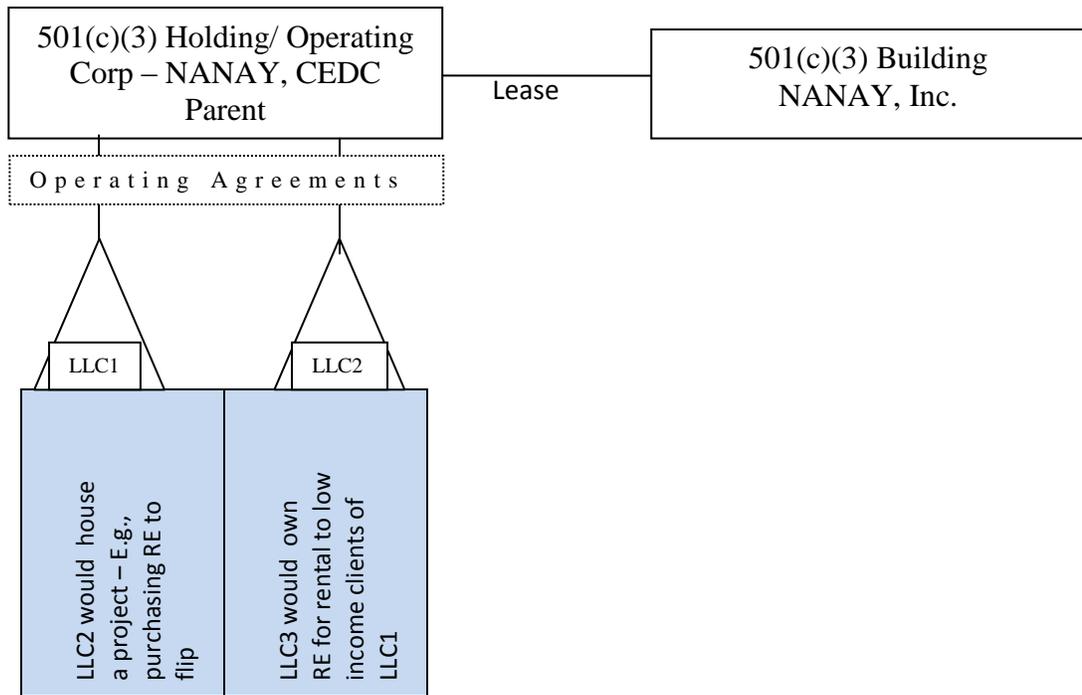
Because NANAY CEDC will be leasing the building from NANAY, Inc., a written lease between the two entities will need to be executed. (This is one of the corporate formalities that must always be observed.)

Also, because NANAY CEDC will be the single member of the operating limited liability company(ies), NANAY Enterprises (represented in LLC1, in diagram below), an operating agreement between NANAY CEDC and NANAY Enterprises must also be executed.

Because NANAY CEDC will be providing the social services in the building owned by NANAY, Inc., and because NANAY, Inc. will be providing the services to the elderly in the building, protection of the liability arising from those activities will be limited. In other words, there remains a possibility that claims related to the activities within the building will create exposure against this asset. However, the activities of the other LLCs, specifically the activities of the for profit LLCs, should not result in additional liability/exposure to NANAY’s main asset.

The diagram below illustrates the proposed structure.

² We note that the ideal structure would be to have a 501(c)(2) corporation, which would be “organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt.” Title-holding corporations are recognized as a way to protect charities from liability claims. However, it is still unclear (and likely doubtful) whether this would be viable in our case. That is, we presume (1) that NANAY, Inc. is the recipient of grants and funding for the elderly services program it currently has, (2) that some of the grants are expressly tied to the ownership of the building, (3) that some grants were conditioned on NANAY’s 501(c)(3) status, and (4) that at least some of the grants would need to be repaid if the building is transferred to another entity. Hence, at least for the near future, we believe we may need to have at least one activity within NANAY, Inc. to preserve the 501(c)(3) status.



Some corporate formalities previously alluded to include:

Holding Scheduled Meetings. The Bylaws³ should specify the number of regular meetings and should also call for an annual board of directors meeting and/or an annual shareholder’s meeting. Holding special meetings of the board when matters of importance come up such as entering into a new lease, entering into a substantial funding commitment, opening a new bank account,⁴ entering into any other significant contractual agreement, changing an officer's salary, filling a vacancy on the board or appointing a new officer, entering into a significant new venture, considering the sale, in whole or in part, of the assets or the dissolution of the business, etc.

Keeping good records – This includes keeping records of all activities and ensuring that each entity’s records are separate and apart from the other, including the minutes⁵ of all meetings, corporate record book (e.g., annual reports, corporate resolutions, accounting and bookkeeping records, bank records, contracts, correspondence, employee records, business forms, intellectual property records, marketing and advertising records, permits and license, tax records, stock records, etc.)

³ All legal entities must adopt bylaws detailing how the internal affairs of the corporation/company will be handled.

⁴ Corporate bank accounts and accounting records must be separate and distinct for each of the legal entities, including the limited liability company. Transfer of funds between the entities must be explained and accounted for.

⁵ The corporate minute book contains a written record of actions by the shareholders and directors of the corporation. At a minimum, there must be annual minutes reflecting the election of directors by the shareholders. Any significant corporate activities, including corporate borrowings, purchases, and the payment of compensation to officers, should be properly reflected in the minutes of the meetings of the directors and shareholders.

Separating each company's finances and other activities. This includes having separate financial and accounting records, signing all contracts in the name of the corporation,⁶ with a signature block that includes the name and title of the individual signing for the corporation (which should follow either the Bylaws, Articles or corporate resolution on authorized signators), making all corporate purchases in the name of the corporation, keeping separate bank accounts, etc.

Other important details:

- Carry reasonable insurance on the corporation, considering the risks inherent in the corporation's business
- Make sure you fund the corporation at the time of incorporation with enough money to keep it going during an initial phase of operations
- Set up a review mechanism for decision-making, so that all aspects of a proposed course of action will be considered
- Comply with Articles of Incorporation, the Bylaws, and other organization documents or contractual restrictions
- Directors and officers owe a fiduciary duty to the corporation, meaning that they must at all times do what is in the best interest of the corporate entity and its shareholders and must also keep corporate matters confidential to the extent possible. An annual commitment from Board members is recommended.
- Developing a Planning Routine: This would entail reviewing each year's activities during the final month of the fiscal year, budgeting ahead for the longest period reasonably possible (and reviewing and analyzing results at least semi-annually), reviewing operations to ensure tax planning is properly emphasized, developing formal long-range planning capacities beyond the budgeting process.

We cannot emphasize enough the importance of observing the corporate formalities. Having mentioned some of the corporate formalities that must be observed, we also note some of the reasons that the courts have ruled will cause the "piercing of the corporate veil". These include the comingling of the corporate funds with other corporate funds or personal funds, using corporate assets for personal use, inter-company transactions that are not arm's length and failing to maintain adequate records.

CONCLUSION:

During our meeting I believe you expressed your desire to have NANAY Enterprises under NANAY, Inc. However, for the reasons cited above it is my recommendation that the for profit entity be incorporated as a limited liability company with NANAY CEDC as the single member.

⁶ When doing business with third parties, the officers and directors must make it clear that they are acting on behalf of a specific corporation/legal entity. Correspondence should be sent out under the proper corporate letterhead, and contracts should be entered into only with the corporation as a signatory. Unless the documents clearly reflect that a transaction is entered into on behalf of the corporation and all necessary agreements are entered into under the corporation's name, the corporate entity will not survive a challenge in a lawsuit.