

# How a National Association and Its Chapters Can Avoid Legal Pitfalls<sup>1</sup>

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Many national associations permit and encourage the formation of chapters and both benefit as a result. Local chapters are an asset to the national association. They are valuable components of the total strength of the association. At the same time, they present unique legal concerns.

The purpose of this article is to discuss legal matters of particular importance in the relationship of a national association with its chartered chapters and to offer some suggestions for clarifying the legal responsibilities of a national association and its chapters.

## Each chapter a legal entity

Ordinarily, each chapter is a legal entity, separate and apart from the national association.

The national association issues a charter for the chapter, which permits it to operate under the name of the national association.

The grant of charter rights and the acceptance of the charter obligation do not, however, create a principal-agent relationship between the national and the chapter.

This is not always made clear to the chapters. Too often, chapters are unaware of their legal obligations as separate legal entities. Hence, they fail to take necessary or prudent steps with respect to incorporation, liability insurance, tax-exempt status and other matters which they may believe are managed by the national association but which are not.

The national association, therefore, should clearly inform each chapter at the time it is chartered that it is a legal unit which must not only observe all charter obligations but also discharge the legal obligations incumbent upon any self-governing organization. The chapter must observe charter requirements by conforming with bylaw guidelines. But if liability results from the chapter's

actions, such as, for example, a breach of contract by the chapter, an injury at a chapter meeting, or failure to file required reports, the chapter, and not the national association, is responsible.

## Not an agent of the national

In order to maintain this separation, the national must not permit the chapter to hold itself out as an agent of the national. Normal agency rules apply. If the chapter has real or apparent authority to act as an agent, the national may be responsible for the chapter's acts.

If the national asks the chapter to take an action for it (for example, to execute a contract), the national is likely to be responsible. Also, if the national knowingly permits the chapter to claim agent status, and a third person reasonably believes such agency status does exist, the national may be liable for chapter actions.

In most instances, however, the national will maintain its separate status, and the chapter will be solely responsible for its own activities. As the chartering organization, the national should make certain that the chapter is aware of its responsibilities. These responsibilities include: choosing a proper form of association; meeting IRS requirements; avoiding antitrust problems; and obeying state law.

## Should chapter be incorporated?

As a result of misunderstanding their status as separate legal entities, chapters often pay no attention to their legal form — that is, whether they are, or should be, incorporated or unincorporated associations. Too often, chapters simply adopt bylaws suggested or required by the national association and never consider whether additional legal documents should be filed.

Deciding whether to incorporate raises virtually

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the same questions for a chapter as for any other nonprofit organization. The chapter should examine the strictness of the law relating to unincorporated associations in the state where the chapter is located, the filing requirements for nonprofit corporations, and the nature of activities to be undertaken by the chapter.

If the chapter intends to be active in sponsoring functions and entering contracts, legal obligations are likely to arise. Then it may be important to incorporate, because incorporation limits this liability to the assets of the corporation. This relieves individual members of any liability for association obligations. Depending on the state and the type of action involved, members of an unincorporated association may be responsible for actions of the association.

In any event, the national can assist the chapter in the choice of form by making sure the chapter is aware of the fact that the adoption of bylaws does not suffice for incorporation under state law, by informing the chapter of the choice between incorporated and unincorporated status, by describing the general differences between those forms, and by providing general guidelines for the chapter to use if it chooses to incorporate.

As a separate legal entity, the chapter is obligated, with one exception discussed below, to separately qualify with the Internal Revenue Service and state tax authorities for tax-exempt status.

Also, if income exceeds the threshold limits for filing, the chapter must file its own information return each year and pay tax on any unrelated business income.

Each year, there are many instances of chapters failing to file information returns, and when the notice of penalty arrives, their defense is as classic as it is futile — ignorance of the law.

The national can provide assistance to chapters in regard to federal tax status by providing chapters with sample exemption applications. Because chapters of a national generally are similarly structured with respect to purpose and conduct similar activities, sample applications (real application forms completed with typical responses) are easily prepared. They serve a dual function — bringing home to the chapter its duty to

file and making it much easier to file. By informing the chapters of their duty to file information returns (if they have income sufficient to require filing), the national serves its chapters and helps avert the danger of penalties for late filing.

### **Group determination letter**

There is an alternative to individual federal exemption applications by chapters. The national may seek a group determination letter from IRS under which IRS not only determines that a national is exempt but also includes within the exemption chapters that want to be included.

In order to qualify for a group determination letter, the national must file a completed exemption application form, a sample form of bylaws that is generally conformed to by chapters, and a consent form executed by each chapter wishing to participate in the group letter.

The national association must also control the chapter. This does not, however, require a degree of control that destroys the status of the chapter as a separate legal entity. Power to revoke the charter and to require adoption of bylaws in accordance with national requirements is sufficient.

Once the group determination letter is received, the national must annually inform IRS of chapters dropping from the rolls of included chapters and of new chapters wishing to be included, and send executed consents in order for the new chapters to achieve exempt status. The group letter, therefore, makes it unnecessary for chapters to file individual exemption applications.

The national does not automatically take over the duty to file information or unrelated business tax returns for the chapters by accepting a group letter. Therefore, chapters must remain particularly careful to file returns.

### **Laws must be followed**

The chapter not only has the duty to choose its own form of business and to qualify as a tax-exempt organization; it also must follow the prescriptions of all other federal and state laws relative to associations. Of particular concern with trade associations is the necessity that they take every precaution to avoid violating antitrust laws.

Although a review of the antitrust laws affecting

associations is not within the scope of this article, national associations should be aware of possible antitrust implications in connection with chapters. Most national associations are aware of the risk involved in excluding competitors from membership in a trade association.

Therefore, if a membership relationship between a national and a chapter is established in such a way that the chapter may be able to deny a competitor membership in the national association — by virtue of having the right to deny membership in the chapter — then an arbitrary decision by a chapter to deny membership may have repercussions for the national association. In other words, just as in other areas of association activity, the national must be careful not to turn over decision-making authority to the chapter when that authority, if used arbitrarily or capriciously, may result in antitrust liability to the national

organization.

#### **Informing chapter of obligations**

Chapters are valuable components of a national association. As such, the national association will doubtless want to provide any possible assistance to the initiation and success of the chapters. Part of this assistance should consist of informing the chapter of its obligations as a separate legal entity with respect to the choice of form of business and tax-exempt status. By providing information and guidance, the national association can ensure that the chapter operates on a sound and effective basis for the good of the entire organization.

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#### **ABSTRACTS**

**BAGLEY, W.T. 1979. Hackberry — a hardy plant often overlooked.** *Am. Nurseryman* 150(3): 15, 88-89.

The hackberry's ability to withstand adversity has been overlooked in recent years as trees are selected for ornamental plantings in the Central Plains region. Although there are no serious insect or disease problems, the leaf nipple galls caused by insects of four pachypsylla species detract from its appearance. Occasionally the witches'-brooms caused by eriophyes species, a gall mite, working in conjunction with powdery mildew fungus, can cause unsightly deformity. Phenological information and injury to trees due to drought or cold in the Nebraska and Kansas plantations are compared. It is quite likely that there are many variants in the total population within and beyond the extremes described. Eventually the original and the other test plantations can be used as seed orchards. The result should be hackberry nursery stock improved in uniformity, vigor, and adaptability to Great Plains sites.

**LEWIS, C.E. 1979. Interesting tree trunks.** *Am. Nurseryman* 150(1): 12-13.

Tree trunks are fascinating. Whether the trees are found deep in the forest, gracing the front lawn of a home or along a street, people can enjoy the various trunk characteristics by merely stopping and looking. The few tree trunks pictured here show the diversity among the different trees. Tree trunks may differ in size, color, character, smoothness or roughness of the bark, and the way the branches break from the main trunk. A tree trunk can be viewed from close range, but it is better to view the whole trunk as a unit and then gradually move in to observe the details.