DOCUMENT RESUME

ED 145 925 24 PS 009 575

AUTHOR Aikman, William F.
TITLE Day Care Legal Handbook: Legal Aspects of Organizing and Operating Day Care Programs.
INSTITUTION Day Care and Child Development Council of America, Inc., Washington, D.C.; ERIC Clearinghouse on Early Childhood Education, Urbana, Ill.
SPONS AGENCY Ford Foundation, New York, N.Y.; National Inst. of Education (DHEW), Washington, D.C.
PUB DATE Sep 77
NOTE 99p.
AVAILABLE FROM ERIC Clearinghouse on Early Childhood Education, University of Illinois, 805 West Pennsylvania Avenue, Urbana, Illinois 61801 (Catalog No. 168, $4.00)

EDRS PRICE MF-$0.83 HC-$4.67 Plus Postage.
DESCRIPTORS Administrative Organization; *Business Administration; Child Care; Contracts; *Day Care Services; Fire Insurance; Health Insurance; *Legal Problems; *Legal Responsibility; *Organization; Personnel Policy; *Preschool Education; Recordkeeping; Taxes; Unemployment Insurance; Workmans Compensation

ABSTRACT

This guide for providers of day care services presents information on business regulations and other legal considerations affecting for-profit and not-for-profit day care programs. Three basic topics covered are: (1) choosing the type of organization (sole proprietorship, partnership or corporation), (2) forming the organization, and (3) operating the program. The chapter on organization types describes each type in terms of general characteristics, ease of operation, nature and extent of liability, and tax status. The following chapter presents a step-by-step description of formation procedures for each type of organization, as prescribed by state laws. Chapters on program operation cover financial procedures (including social security and tax requirements), tax exemption, personnel policy, contracts, and insurance (including workman's compensation, fidelity bonds, and health, liability, automobile, unemployment, and fire and theft insurance). A final chapter considers issues of liability resulting from accidents or other types of torts, or from breaches of contract, in terms of legal relationships among staff members, director and board of directors. (BF)

DAY CARE LEGAL HANDBOOK:
LEGAL ASPECTS OF ORGANIZING AND OPERATING DAY CARE PROGRAMS

by
William F. Aikman, Esq.

Available from:
ERIC Clearinghouse on
Early Childhood Education
University of Illinois
805 West Pennsylvania Avenue
Urbana, Illinois 61801

Price: $4.00 Catalog #168

September 1977

Publication of this handbook was made possible through the cooperation of the Day Care and Child Development Council of America.

First printing, Center for Public Interest Law, 1977
Second printing, Southern Regional Education Board, 1977
Third printing, ERIC Clearinghouse on Early Childhood Education, 1977

The material in this publication was originally produced in part with funds provided by the Ford Foundation under a grant to the Day Care and Child Development Council of America, Inc. The present publication was prepared pursuant to a contract with the National Institute of Education, U.S. Department of Health, Education and Welfare. Contractors undertaking such projects under government sponsorship are encouraged to express freely their judgement in professional and technical matters. Points of view or opinions, however, do not necessarily represent the official view or opinions of the National Institute of Education.

TABLE OF CONTENTS

INTRODUCTION: THE "BUSINESS" OF DAY CARE

Many important aspects of a day care program are affected by, often even controlled by, legal considerations. The overriding purpose of this Handbook is to alert people who are involved with day care programs to this fact. In part, the legal considerations arise because day care centers provide a service which society has determined should be subject to official regulation. In part, however, these considerations arise solely because the day care center is a business.

People who are involved in day care usually do not like to think of themselves as being involved in a business because of the connotations which the word "business" has among professionals in their field. But a day care center <u>is</u> a business. A great many day care programs are organized as nonprofit corporations. When speaking of this organizational form, however, it is common for people to put all the stress on the word "nonprofit" and completely ignore the word "corporation". A nonprofit corporation is just as much a corporation as the most profit-conscious industrial corporation and, consequently, it is subject to many similar types of regulations and requirements. Similarly, if several individuals band together--"form a partnership" in legal terms--to run a day care center, they are operating a business just as much as if they had banded together to run a dry cleaning establishment.

The goal of this Handbook is to provide information and ways of thinking about that information which will enable people concerned about day care to think about the legal aspects of running a day care program in an informed and responsible manner. The material in the Handbook addresses three basic questions:

- How to determine which type of organization is best for your day care program;
- How to form that type of organization;
- How to operate the day care program in a legal manner once the organization is formed.

The Handbook is organized so that each chapter builds on the preceding one. However, an attempt has been made also to write each individual chapter in a way that makes it comprehensible on its own. A detailed table of contents appears before the first page of each chapter.

This Handbook discusses many of the important legal issues confronting providers of day care services, but by no means does it cover all the important legal issues. Constraints of time and money made it impossible for the Handbook to be an all-comprehensive treatment of legal considerations affecting day care. However, a much-expanded edition of the Handbook is being planned for future publication.

In order to determine which topics to include and which to omit, the following criteria were adopted: (1) to omit those topics on which there were sources of information in existence already, even if those sources were not of the quality we'd prefer; (2) to omit topics which most day care providers have a general awareness of already, even if there are no written materials on them currently; (3) to omit topics which, in comparison with others, were clearly of less critical importance; and (4) on the assumption that an expanded version of this document will be published in the future, to include the types of basic information which, in effect, constitute the building blocks on which later material could be added most logically.

Given the widely varying experiences, problems, and stages of development of day care around the country, it was not possible to write for a nationwide audience without including material that in some cases is inapplicable to local situations. In general, an effort is made throughout the text to present information from a national perspective. This effort required resorting to broad generalizations in many instances since the relevant legal rules about various matters vary from state to state. The principal usefulness of this general material is to alert the reader to issues and to suggest ways of thinking about issues. On the other hand, specific details of general applicability are provided wherever possible.

The research and writing of the Handbook were supported in part by funds provided by the Ford Foundation. In large measure, the impetus for the Handbook came from the efforts of Gwen Morgan and James Levine, from the Day Care and Child Development Council of America, Inc., and I am thankful to them for the encouragement and advice they gave me. I would like also to express my gratitude to the following individuals for their assistance and support throughout various stages of the preparation of the Handbook: Susan Berresford; Sylvia deMurias; Marjorie Grosett; Stacie Jacob, Esq.; Lawrence Kotin, Esq.; Annice Probst; Theodore Taylor; Nancy Travis; and Nancy Wilson.

William F. Aikman
Boston, Massachusetts
April, 1977

CHOOSING AN ORGANIZATION TYPE

OVERVIEW

THE MAJOR ISSUES

Ease of Operation

Nature and Extent of Liability

Torts

Breaches of Contract

Tax Status

Profit-Making Centers

Not-for-Profit Centers

TYPES OF ORGANIZATIONS

Sole Proprietorships

Partnerships

General Partnerships

Limited Partnerships

Capacity to be a Partner

Corporations

Profit or Not-for-Profit

Taxable or Tax-Exempt

CHOOSING AN ORGANIZATIONAL STRUCTURE: COMPARATIVE CHARACTERISTICS

Characteristics of Sole Proprietorships

Characteristics of Partnerships

Characteristics of Corporations

Chapter I

CHOOSING AN ORGANIZATION TYPE

OVERVIEW

In order to avoid a multitude of potential problems, it is important for people concerned about day care to recognize the aspects of day care which are affected by business regulations and other legal considerations. This is especially true for center program directors who are hired by the board to handle such matters and not simply to run a good center in programmatic terms.

In thinking about operating a day care program, the first legal matter which must be decided is the question of what type of organization should be used for the program. Essentially, this is a matter of matching the legally permitted types of organization with the needs and plans of the program operators and consumers and deciding which type "fits best". The decision about type of organization is the initial decision around which all other legal-related decisions will focus. It is the decision which determines the legal structure, as opposed to the physical structure (i.e., the building), within which all the program's activities must take place.

There are three major types of organizational structure which can be used for the operation of a private day care program (i.e., one not run by a governmental agency):

- sole proprietorship:
- partnership;
- corporation.

Two of these types, the partnership and the corporation, each have several sub-types with important differences among them. The number and nature of legal rules and regulations affecting the day care program vary depending on which of these basic types of organizational structure it adopts.

This chapter has three purposes: (1) to outline the major issues which should be considered when deciding which organizational structure to use for the program, (2) to describe the basic types of organizational structure which can be used for programs, and (3) to compare the characteristics of each of those organizational types.

No hard and fast rules can be given about which type of organization is "best" for a day care program. The best organizational form is the one which most easily meshes with the goals and intentions of those who will operate the program, the requirements and recommendations of those who will be funding it, and the needs and desires of those who will use it. Only the organizers of the program themselves can make this decision; the material in this chapter is intended to raise the questions and provide the information which the organizers should consider in the course of making the decision.

It should be understood at the outset, however, that in a number of situations the decision about organizational structure will be dictated by financial considerations. This is because in a number of states day care centers are required by law to be incorporated before they can be eligible to receive governmental funds (for instance, Title XX funds).

THE MAJOR ISSUES

Whether you are starting a day care center, changing the organizational form of an existing day care center, or creating another organization which will be affiliated with a day care center, you should think through several important issues before making a final choice as to type of legal organization. There are three major issues which should determine the decision:

- the ease of operation which the organizers consider necessary;
- the nature and extent of liability which the organizers consider acceptable;
- the type of tax status which is desired.

After the organizers of the center have thought through their positions regarding each of these issues, it should be relatively clear which of the basic forms of organization is most adaptable to their needs and intersts.

Ease of Operation

The issue of ease of operation is largely a determination of how much managerial complexity the organizers are willing to take on and how much flexibility they expect will be necessary in order to keep the organization viable. This determination can be made by thinking about three things: (1) the volume and complexity of daily tasks which the individuals who will be operating the center will be able to undertake effectively and responsibly, (2) the volume and complexity of long-term tasks which those same individuals will be able to undertake effectively and responsibly, and (3) the relative ease of making changes in the daily and long-term operational tasks, as well as in the individuals performing them, which will be necessary to the success of the organization.

The daily tasks of operation include such matters as bookkeeping, communicating with funding sources, dealing with licensing and other regulatory agencies, dealing with vendors, etc. The long-term tasks include such matters as filing periodic reports with state and federal tax authorities, with local and state permit-granting authorities and with other official governmental agencies, as well as such matters as preparing for financial audits and developing reliable projections of income and expense, staffing needs, etc. The ease with which changes can be effected in the operational tasks and in the personnel performing them can be important if the organizers are unsure of the future directions of their venture or if they suspect that a certain level of operations may become too complex or too time-consuming to be maintained.

Nature and Extent of Liability

The issue of the nature and extent of acceptable liability is basically a question of the amount of potential personal financial responsibility to which the people running the center are willing to expose themselves. In other words, to what extent are the people running the center willing to run the risks of being personally liable for any expenses that might result from anything which goes wrong at the center. The catalog of things which might go wrong is, of course, nearly endless and includes everything from children getting burned in the kitchen to bookkeepers being overly generous with governmental funds.

The core of this issue is the decision about whether the people running the center are willing to take the risks: (1) that something serious might go wrong, (2) which result in someone having a valid claim against the center for a considerable amount of money, (3) which the people running the center would have to pay out of their own pockets--or whether they wish the maximum amount of insulation from these risks which can be legally arranged.

To be fully informed about the factors influencing this decision, it is necessary to be somewhat familiar with the various types of liability which the law creates. The law imposes liability--usually in the form of financial penalties--for three basic categories of acts:

- crimes;
- torts;
- breaches of contract.

In terms of the operation of day care programs, it is liability for torts and breaches of contract which are most important.

Torts. A tort is a civil wrong. It is an act which the law penalizes but which is not a crime (hence the description "civil"). Leaving a banana peel on the floor where someone might slip on it is a tort. Failing to shovel the snow off your steps before the kids arrive is a tort. Saying things about another person which amount to slander is a tort. Taking home and using as your own a piece of personal property--such as a coat--which someone left in the center is a tort. Virtually any act which is punished by the law and which is not a crime and not a breach of contract is a tort. (For a fuller description of the varieties of torts, see the "Varieties of Legal Responsibility" section of Chapter VI.)

Torts are wrongs which are committed either against "the person" (the body) of another individual or against property belonging to another individual. It is not uncommon for a certain act to be both a tort and a crime. When this is the case, the act is sometimes given the same name, both as tort and as crime, and is sometimes given different names, one to characterize the act as a tort and another to characterize it as a crime. An example of the same-name category would be a situation where you enter someone's home without a prior specific invitation; this is called "trespass" both in criminal law and in tort law. An example of the different-name category is taking someone's coat and using it as your own; this is called "larceny" in criminal law but is called "conversion" in tort law. The act is the same, it's just given a different name depending on whether you think of it as a crime or as a tort.

Whether the act is treated as a crime or a tort is determined by the "victim" (the owner of the house or the coat). Wherever an act is illegal under both criminal law and civil (tort) law, the victim has a choice as to whether to pursue a criminal remedy or a civil remedy. If the criminal route is chosen, the victim will file a complaint with the police charging you with a crime. If the civil route is chosen, the victim will file suit against you demanding to be paid "damages" (money).

Breaches of contract. The other major area of civil law which carries the constant possibility of personal financial liability being imposed is the law of contracts. Every day care center enters into dozens of contracts in the course of the year. Frequently, however, the operators of the center do not realize that the transaction involves a contract. This usually occurs because of the mistaken notion that a contract has been entered into only when one signs a very formal looking document that is written in very official language and is forbiddingly labelled "Contract" or "Agreement" at the top. In fact, binding contracts can be entered into in a number of different ways and do not require any particular formalities--not even a written statement.

A transaction does not need to be called a contract by the parties in order to be a contract. A mere purchase order can be a contract if properly issued by the center and properly filled by the recipient of it. An oral contract may be entered into which is just as binding as the most official-looking contract written on parchment.

The essential elements of a contract are explained in Chapter V. If these elements are present in any transaction, a valid contract has been entered into. Valid contracts are said to be "binding" on each party. This means that if one party violates a condition of the contract--"breaches" it in legal terms--then he or she becomes legally liable to the other party for the financial consequences of that breach.

In terms of amount of potential ultimate financial liability, torts give rise to much greater concern than breaches of contract since, usually, the amount of loss caused by a tort is much greater than that caused by a breach of contract. On the other hand, the amount of loss from a breached contract can be substantial if a day care center is a reasonably large operation, and also if leases, which are considered to be contracts in most states, are breached. In addition, as is explained in Chapter V, it is possible to protect oneself against tort liability through insurance but, with certain limited exceptions, no such protection is available against liability for breaches of contract.

Because of the obvious tremendous impact of a finding of personal liability for the financial consequences of a tort or a breach of contract, many people trying to determine the appropriate legal form for their day care program choose that form which most minimizes this potential liability. The form which gives the most protection against personal liability is the corporation, as is explained in sections of this chapter.

Tax Status

Profit-making centers. For day care centers which are being organized on a profit-making basis, the issue of the type of tax status which is desired for the center poses to the organizers what is really a four-part question: Who gets taxed, when, at what rate, and involving how much paperwork?

The question of <u>who</u> gets taxed involves deciding whether the individuals operating the center prefer to take the center's income as their own and pay taxes on it personally or whether they prefer the center--as an organization--to pay its own taxes and take their personal income only in the form of salaries and dividends.

The question of <u>when</u> taxes are paid simply involves remembering that, depending on the type of organization and on the amount of income involved, various taxes may have to be paid on differing time bases, e.g., annually, quarterly, monthly, etc.

The question of <u>tax rate</u> is a reminder that the income of corporations is taxed at a different rate from that of individuals, and also that individuals themselves are subject to a wide range of rates. This must be taken into consideration when trying to decide the most advantageous form of organization.

The question of <u>paperwork</u> is a reminder that the amount of paperwork (returns, reports, forms, notices, etc.) required by federal and state tax authorities varies, depending on the legal form of organization adopted for the day care program.

The implications of each of these questions will become more clear after reviewing the material in the next two sections of this chapter.

<u>Not-for-profit centers</u>. Except for the amount of paperwork required to be filed, the four questions just outlined above need not concern a not-for-profit day care program, provided the program has filed for federal <u>tax exempt status</u>. For programs which are to be operated on a not-for-profit basis, the major tax issue is whether they are organized and operated in a manner which makes them eligible for tax-exempt status. The details regarding tax-exemption

are discussed in the next section; at this point--the time of initial choice of organization form--it is only important to remember that a center must be organized as a not-for-profit corporation before it can be eligible for tax-exempt status. There is no such thing as a tax-exempt partnership or a tax-exempt sole proprietorship.

TYPES OF ORGANIZATIONS

As indicated earlier, there are three basic types of organizational structure within which a day care center can be operated: sole proprietorships, partnerships, and corporations. And both partnerships and corporations exist in several different sub-types, the differences among which have important implications for day care operators.

Sole Proprietorships

The sole proprietorship is the simplest of all types of organization. Indeed, in its most basic form, it is not really an "organization" in the literal sense at all; it is merely a single individual engaged in some self-employment activity. However, even in that basic form, there are certain business regulations and other legal rules which apply so it is classified as a form of organization in the legal sense even if there is, in fact, no real "organization" of any sort to support the individual.

On the other hand, since "sole proprietorship" is a legal category and not a literal description, it is just as possible for a very large organization, composed of dozens of employees, to be a sole proprietorship as for a single individual to be one. The determining factor is simply whether the entire operation, no matter how large or small, is owned by one person who has no partners and is not incorporated.

With only one exception, there are no particular formalities required in order to create a day care center as a sole proprietorship. The one exception relates to the requirement that a "True Name Certificate" be filed if the person operating the center is operating it under any name other than the person's own name. For instance, if Jane Jones is operating a center she calls the Happy Times Child Center, a True Name Certificate would have to be filed or Ms. Jones would be in violation of state law (or local law in some states). (For details concerning True Name Certificates, see Chapter II.)

Partnerships

The partnership is the type of organizational form most oriented toward the needs of people who do not want the total responsibility involved in running a center as a sole proprietorship but who also do not want the complexities involved in running a center as a corporation. The law recognizes two different types of partnerships: general partnerships and limited partnerships.

General partnerships. A general partnership exists when two or more individuals (or organizations) associate together for the purpose of engaging in any business activity, including running a day care center, and their association is premised on equal status for each partner. This premise of equality means that each partner:

- has an equal responsibility with regard to the center's debts or other obligations;
- has made equal contributions to the organization.

The contributions need only be equal in value; they do not need to be contributions of the same nature. Thus, one partner might contribute a certain number of hours per week of time but make no financial investment while another partner might supply the cash needed to start operations and a third partner might supply the furniture and equipment for the center.

It is important to realize that the equality among partners upon which a general partnership is based is a right and not an obligation. With regard to decisions, every partner has the right to participate in making the decisions about the center's policies, personnel, operations, etc., but is not required to do so and may freely waive the right thereby allowing the remaining partner(s) to make the decision alone. Similarly, each partner has the right to expect equality of contribution from the other partners, but that right does not need to be enforced if the partners are content with an "unequal" situation.

However, the opposite is true with regard to responsibility. There is an obligation of responsibility on the part of all partners. All partners are equally responsible for the debts and other obligations of the organization and this responsibility can be enforced by any third party; the partners cannot agree that one partner will bear no financial responsibility for the center. This legally-imposed equal responsibility is the core feature of a general partnership and should be kept very clearly in mind before deciding to operate a day care program through this mechanism.

Limited partnerships. Obviously, there are some people who would be interested in being part of a partnership running a day care center if there were a way of avoiding the obligation of responsibility discussed above. There is a way of doing that to a certain extent. The method of accomplishing this goal is to create what is called in law a "limited partnership" rather than a general partnership.

In a limited partnership there must be at least one general partner (there may be any number more than one) and at least one limited partner (again there can be any number more than one).

The limited partner is "limited" with regard to the all important matter of financial responsibility. A limited partner is responsible for the debts and other obligations of the center only to the extent of the contribution of assets which the partner originally made. In other words, if Jane Jones is a limited partner in the Happy Times Child Center and her original contribution to the center was one thousand dollars in cash and five hundred dollars worth of furniture, the maximum amount for which she could ever be held liable in terms of the center's debts would be fifteen hundred dollars. For the general partners in the Happy Times Center, there is no limit to their responsibility; their personal financial liability for the debts of the center extends to whatever the debts should total (divided equally by the number of general partners, of course) even if this results in liability for an amount which is hundreds of times the value of their initial contribution.

In order to qualify for such limited liability, however, the limited partner must give up most of the rights which the general partners have. In particular, the limited partner has no voice in the daily decisions concerning the center and cannot participate actively even in major decisions unless they concern matters which have an important effect on the center's finances.

Limited partners are really investors who are treating the day care center as an investment. In return for contributing a certain amount of funds to get the center started, or to maintain it, they are entitled to a certain percentage of the center's profit--if and when it has any.

Limited partners do not share in the burdens of running a center and do not share the full potential financial liabilities of running a center (other than to the amount of their contribution). Therefore, the only reason why those who plan to be general partners should agree to form a limited partnership with one or more limited members, rather than a regular general partnership, is if they cannot make their day care center a reality without the limited partner's contribution in cash or in kind.

Capacity to be a partner. Thus far our discussion of partnership has obviously assumed that the partners, whether general or limited, are human beings. This need not be the case, however. It is perfectly legal for a corporation to be one of the partners in a partnership; it is also legal for a sole proprietorship to be one of the partners in a partnership. And a partnership could be composed of a combination of a corporation, a sole proprietorship and a human being (who is called a "natural person" in the law). Thus, for instance, the Happy Valley Area Child Welfare League, Inc. (a corporation) and the Happy Times Child Center (a sole proprietorship run by Jane Jones), and David Drew, a "natural person" with some money to invest, might together form a partnership to run a center in addition to the one Ms. Jones is already running or perhaps even a whole network of centers.

Contrary to a common impression, it is also permissible for minors to be partners. In a number of states, however, minors are not permitted to form corporations so this difference in legal capacity should be kept in mind if one of the organizers of the center is below the age of majority.

Corporations

While it may seem odd at first to think of a corporation as an appropriate structure through which to run a day care center, in fact, in many situations a corporation is the most appropriate structure for operation of a day care center. The explanation for this somewhat startling conclusion lies in the many special advantages the law confers on people who conduct any sort of business through the corporate form. Those advantages will be detailed in the next section but, first, it is important to have some basic knowledge about corporations before being able to consider in an intelligent manner whether to incorporate your day care center. The most elemental piece of information is that corporations come in two separate pairs of categories:

- Profit or Not-for-profit;
- Taxable or Tax-exempt.

The second category is really a sub-category of the first: not-for-profit corporations may be either taxable or tax-exempt.

Profit or not-for-profit. An enormous amount of confusion has resulted from the tendency of people to use the phrase "nonprofit" in place of the proper legal phrase "not-for-profit". Use of the phrase "nonprofit" has led people to reach what seems to them an obvious conclusion--the organization is not permitted to make a profit. This is not true. It is both permissible and indeed common for corporations organized as not-for-profit corporations to succeed at making a profit and, on the other hand, for corporations organized as profit-making corporations to fail to make a profit.

The essential differences between a profit corporation (for instance, General Electric) and a not-for-profit corporation (for instance, the Day Care and Child Development Council of America, Inc.) do not concern whether the corporation's income exceeds its expenses (i.e., whether a literal "profit" is made). The essential differences concern the purposes, powers and responsibilities under which the corporation is organized and operated. Thus the core issue is whether the center was organized for the purpose of being a profit-making endeavor and not whether, in fact, the center's income exceeded its expenses.

It is true that a day care center could not be organized as a not-for-profit corporation if the organizer's purpose in establishing the center in the first place was to run it as a profit-making business. But, if, once the center is organized on a not-for-profit basis, it makes a surplus (has income in excess of expenses) some years, it doesn't need to "give back" the surplus which could be called its "profit". It can use that money to increase salaries, or purchase equipment, or hire additional staff, or have renovations done, or put it in a fund to be spent on similar purposes in future years.

The only legal restriction is that the money must be used in some way which furthers the purposes for which the center was created. (These purposes are outlined in the initial document you file in order to get incorporated.) It is this restriction which precludes the profit from being paid out to the organizers, or other financial supporters, as dividends. So, a not-for-profit day care center can legally make a profit but it cannot pay that profit over to its organizers or others in the way a center incorporated as a profit corporation could. It can, however, reward paid staff for their efforts through using any profits to increase salaries.

Taxable v. tax-exempt. All corporations formed for profit-making purposes are automatically subject to taxation. Many people believe that, conversely, all organizations formed as not-for-profit corporations are automatically tax-exempt. This is not true. The organizers of a not-for-profit corporation must file an application for tax exemption. They do not receive tax-exempt status automatically merely by virtue of being a not-for-profit corporation. Many current operators of day care centers around the country appear to be unaware of this fact and have been running centers on the assumption that they were tax-exempt "because we're nonprofit". This incorrect assumption could potentially lead to a great deal of difficulty with the Internal Revenue Service and with state tax authorities. A not-for-profit corporation which has not filed for tax-exemption or, having filed, has been denied an exemption is subject to taxation.

Another very common assumption among operators of day care centers is that if an organization has received tax-exempt status from IRS, it is automatically also exempt from state taxes. This is not true in most states. Again, an application for exemption from state taxes must be filed with the appropriate state authorities. While in many states the application will be granted automatically if federal tax exemption has already been obtained, the day care center will not be exempt from state taxes until that application is granted.

CHOOSING AN ORGANIZATIONAL STRUCTURE: COMPARATIVE CHARACTERISTICS

There are many differences, all of which are established by law, regarding the powers, duties, liabilities and other aspects of the forms of organization we have been considering (sole proprietorship, partnership and corporation).

Of these differences, there are perhaps half a dozen major ones and it is these which should be the determining factors in deciding what legal form to choose for a day care center. These major differences in organizational characteristics involve:

- The extent of personal financial liability imposed on the operators of the center;
- The nature of the decision-making processes which the center may use;
- The ease with which the original operators of the center may transfer it to others or change its basic form;
- The types of tax obligations which are incurred;
- The requirements regarding what happens when the center "goes out of business";
- The extent of the paperwork involved in creating and in operating the center.

The following discussion will summarize the rules regarding each of these points for each of the forms of organization.

Characteristics of Sole Proprietorships

In a day care center organized as a sole proprietorship, the owner (who is usually also the operator) has full personal liability for the financial consequences of all aspects of the center's operation. This includes liability for debts, for breaches of contract, for torts, for taxes and tax penalties, for regulatory fees, etc. The liability is said to be "full" because it is not limited in amount; all the center's obligations must be met from the owner's personal funds (including the value of assets such as cars) no matter how large the obligation (including obligations in amounts which exceed the owner's total personal funds).

As a corollary to full liability, the sole proprietor has full decision-making authority. There are no restrictions of any type about the decision-making process and the sole owner may do with the center whatever the owner wishes whenever the owner wishes and in whatever manner the owner wishes (consistent, of course, with any governmental licensing or other regulations generally applicable to day care centers).

A day care center run as a sole proprietorship has free and immediate transferability. The owner can sell the center at any time to anyone the owner wishes or give it away to another individual or to any organization or simply close it and go out of business.

The income from a sole proprietorship center is treated as the owner's personal income and therefore there are no non-individual tax obligations or forms to be filled out. The owner simply reports the income earned from the center on Form 1040 after filling out Schedule C (Profit or Loss from Business or Profession). It is on Schedule C that the owner will report the center's gross income and itemized expenses and whether these resulted in a net profit or loss for the year.

If the owner-operator of the center decides, for whatever reason, not to run the center any longer, there are no restrictions on going out of business. The owner may simply stop receiving the children, pay any outstanding debts of the center, and there is nothing else involved. The legal life of a sole proprietorship organization ends whenever the sole proprietor says it does.

There is almost no paperwork involved in the creation or operation of a sole proprietorship. Only one document is required to legally open a center as a sole proprietor and that one is needed only if the center is given a name other than the owner's name. This document is the True Name Certificate and, using the example given earlier, must be filed if the owner of the center is, for instance, Jane Jones but she calls the center (even though "the center" is in her house) the Happy Times Child Center. There may, of course, be other documents required of all centers, no matter what their form, by licensing and other regulatory authorities.

Characteristics of Partnerships

In day care centers which are operated as partnerships, all general partners have full personal liability for financial obligations of the center to the same extent that they would have if they each were operating the center as sole proprietors. What distinguishes the general partnership from the sole proprietorship with regard to liability, however, is that each partner has the right to demand that every other partner share equally in any financial obligations. In a partnership where there are limited partners, the limited partners are personally liabile only to the extent of their capital contribution. The capital contribution is the total value of whatever the limited partner contributed to the formation of the center whether the contribution was in the form of cash, furniture, equipment or other assets.

In a general partnership, each partner is co-equal in decision-making and, as a result, each partner has full authority to make binding decisions independently of the other partners. This means that any decision which any partner makes, for instance, to purchase a typewriter or to admit a child to the center or to order food from a grocery, is binding on the organization--and on the other partners personally--even if the other partners never knew the decision was made. This aspect of the law of partnership is one which many people contemplating the operation of a day care program as a partnership seem unaware of.

A partnership has only very limited transferability. A partner may only sell or give away her or his interest in the partnership if all the other partners consent to such a transfer. By law a partnership is automatically dissolved whenever one of the partners dies. A center operated by a partnership can legally operate after the death of one of the partners only if the surviving partners form a new partnership, or some other form of organization, to continue the activities. No change in basic organizational form, for instance from partnership to not-for-profit corporation, can be made without the consent of all the partners.

As with a sole proprietorship, people running a day care program through a partnership will have no non-individual tax obligations. Unlike a sole proprietorship, however, the partnership does have to file an informational return, called Form 1065, even though the income the partners receive from their day care program is taxed to them as individuals. There is no separate tax on partnerships.

By law, a partnership automatically goes out of business whenever a partner withdraws from the "business" or dies or becomes permanently incapacitated or becomes insane. (Hopefully, not too many day care providers are driven to insanity; nevertheless, there are those who have concluded it would be insane to go into the day care business in the first place if all the relevant facts were known in advance!) As indicated above, the surviving partners must form a new organization if they wish to continue their day care activities once one of the above events afflicts a partner.

Depending on whether the partnership is a general one or a limited one, there will be only one or two documents required to operate a day care program in a partnership form. If a general partnership is the chosen form, only a True Name Certificate will have to be filed. If there are limited partners involved also, a Limited Partnership Certificate must be filed in addition to the True Name Certificate. Although no other documents are legally required in order to operate a day care partnership, it is desirable in many situations to prepare a Partnership Agreement. All of these documents are discussed in the next chapter.

Characteristics of Corporations

While partnerships and sole proprietorships have some important characteristics in common, corporations are quite different with regard to the major issues of concern to day care providers.

If a day care program is run by a corporation, no matter whether for profit or not-for-profit, the corporation will have a legal existence separate from that of any of the people who create or operate it. It is this separate entity, the corporation, which incurs any financial liability which arises in the course of providing day care services, no matter whether the liability is in the form of ordinary debts or contract breaches or tort claims or tax penalties, etc. Consequently, there is, with only a few minor exceptions, no personal liability for anyone involved in the operation of a day care center through a corporation. This absence of any personal financial liability is the principal reason why people choose to form corporations rather than conduct their activities as sole proprietorships or partnerships. With regard to day care programs, which typically are run on a fairly small scale, this lack of liability feature will frequently be the most important element in the decision about which organizational form to choose.

The corporation will have a Board of Directors which is legally charged with the responsibility for making all major decisions regarding the activities of the center. As indicated above, however, the members of the Board will not have any individual liability for those decisions or for any other actions, with only the following exceptions: Board members can be held personally liable for the failure of the corporation to pay withholding taxes on employees' salaries, for failure to pay state unemployment taxes in some states, for fraud, and for gross negligence in their duties as Board members (where the negligence resulted in some financial loss to the organization).

In a day care program operated by a corporation, there must be a hierarchial decision-making structure. All major financial and policy decisions, including such matters as the program's rules on admission of children, must be made by the Board of Directors or someone acting on general instructions from the Board. Normally, the Board will delegate considerable decision-making authority to an Executive Director, but the Board remains responsible for that person's actions. The Executive Director, in turn, will be empowered by the Board to further delegate some matters to staff members, for instance, to the Head Teacher regarding program questions and to a part-time bookkeeper regarding fiscal questions. Although an Executive Director may run a day care program in fact, particularly on a day-to-day basis, she or he has only those powers granted by the Board; any major action which an Executive Director takes which is not based on advance instructions from the Board is binding (i.e., legally enforceable) on the organization only if the Board subsequently ratifies the Director's action. (There are some exceptions to this general rule which are mentioned in the chapter on Board/Director/Staff Legal Relations.)

In a corporation, the issue of transferability is complicated to a greater extent than in the other organizational forms. If the corporation is organized for profit, there will be shareholders and those shareholders can transfer their interest in the organization (their shares) by sale or gift at any time they choose. Unlike the situation with partnerships, such transfer does not have any effect on the legal continuity of the organization. A corporation exists as a legal entity forever unless it is formally dissolved by the Board of Directors or by a court.

If the corporation is organized on a not-for-profit basis, no one has any ownership interest in it to transfer. If the not-for-profit corporation has acquired tax-exemption, very strict rules govern the manner in which any of its assets can be transferred to another organization or to any individuals. Basically, individuals may not receive anything of substantial value from a tax-exempt organization except as payment for services rendered. And the organi- may not pay over funds to any other organization except as payment for goods and services rendered or as a donation to some other tax-exempt organization. Transfers of decision-making responsibility are accomplished simply by electing new members to the Board of Directors.

Regardless of whether the individuals running an incorporated day care program are doing so on a taxable or a tax-exempt basis, they will have to file numerous tax forms in addition to their own individual forms (on the individual forms they would report the salary and other income, such as dividends, which they drew from the program during the year). There are several varieties of both annual and quarterly returns which must be filed and the forms on which this is done differ depending on whether the organization is tax-exempt or not. The forms which an exempt day care center must file are discussed briefly in Chapter IV on Operation of the Center. The important point to remember is that you will be under the legal obligation to file these returns in an accurate and timely manner if you decide to incorporate your program rather than run it as a sole proprietorship or partnership.

When an organization is incorporated, its manner of going out of business is regulated by state law in a fairly strict way. Since there are many differences from state to state, it isn't possible to summarize them here. If the organization is also tax-exempt, the manner in which it goes out of business is also regulated by federal law and it is the federal regulation which is most important. The core of the federal rule is that when a tax-exempt organization goes out of business it must give away to some other tax-exempt organization(s) any assets it has left over after paying its debts. No assets (nor the proceeds from the sale of any) can be kept by the staff, directors, or members of the organization.

Usually, this rule poses no problem because most tax-exempt organizations go out of business because their assets are inadequate to meet their debts. However, that is not always the case, and people considering incorporating a tax-exempt day care program should clearly understand that any assets the organization may have whenever they decide to terminate it are not "theirs"; they belong to the corporation and federal law requires the corporation to give them away.

In order to organize and then operate a day care program on an incorporated basis, a wide variety of documents are required. Some of these only have to be prepared and filed once while others must be prepared on an annual, quarterly or, occasionally, even more frequent basis. Among these documents are the Articles of Incorporation, the By-Laws, Minutes of Board of Directors' Meetings, Statements of Financial Condition and Minutes of the Annual Meeting of Members, all of which are discussed in Chapters II and III. When all these documents are added to those which are required by state licensing authorities and to those already mentioned relating to taxes, it should be apparent that operating an incorporated program can involve a very considerable amount of paperwork. This is the price the state exacts in return for giving you the freedom from personal liability which incorporation brings.

FORMING THE ORGANIZATION

SOLE PROPRIETORSHIPS

PARTNERSHIPS

General Partnerships

Limited Partnerships

CORPORATIONS

Articles of Incorporation

By-Laws

Incorporator's Meeting

Filing the Articles

Chapter II

FORMING THE ORGANIZATION

As the previous chapter has explained, it is important to give careful consideration to the type of organization which best suits the needs and plans of the individuals and groups who will be operating and utilizing the day care center. The decision about type of organization is the initial decision around which all other legal-related decisions must center. It is the decision which determines the legal structure, as opposed to the organizational structure (staffing pattern) and physical structure (building), within which all the center's activities must take place.

This basic decision regarding type of organization should be made after thinking through the three major issues discussed in Chapter I: ease of operation, nature and extent of liability, and type of tax status.

Once the decision concerning the most appropriate type of organizational structure has been made, the next task is to take those steps which are required by law for the proper formation of the organization. These steps are prescribed by state law, and, to a much lesser extent, local law. It is very important to follow these steps carefully and exactly because failure to do so can result in numerous later legal problems which may be the undoing of the program as well as the source of very serious difficulties for the individuals who formed and operate the center.

Luckily, however, the steps required to properly form two of the organizational types, sole proprietorships and partnerships, are exceptionally simple and can be done by anyone. The steps required to form a corporation are considerably more complicated, but nevertheless can often be done without an attorney. Where the decision has been to create a tax-exempt corporation, however, consultation with an attorney is advisable because of the additional complexities created by the process for seeking tax exemption. Even here, however, there is no requirement that the tax exemption application be filed by an attorney, and it is certainly possible to be successful in acquiring the exemption without the assistance of an attorney.

SOLE PROPRIETORSHIPS

The sole proprietorship is the simplest of all types of organization. In most states, a sole proprietorship is created simply by filing what is called a "True Name Certificate" with a governmental official who is usually a town or city clerk. (In some states this document is called a "Fictitious Name Registration".) The purpose of the True Name Certificate is to reveal (to creditors, to official authorities, to banks, etc.) who the owner of the business is.

The True Name Certificate requirement exists because many sole proprietorships, including most day care centers which are operated as sole proprietorships, are operated under a name other than the individual who actually owns the organization.

For example, Jane Jones may be operating a small center which she calls the Happy Times Child Center. In this case, Ms. Jones is said to be "doing business as" the Happy Times Child Center. "Doing business as" is usually abbreviated to "d.b.a." by banks, insurance companies and businesses. Thus, the official transactions involving contracts and other types of legal arrangements will be between the bank or insurance company or whatever on the one hand and "Jane Jones d.b.a. Happy Times Child Care Center" on the other hand.

In many instances, however, Ms. Jones, or her staff, will enter into transactions (such as purchasing supplies or ordering food or hiring a plumber) solely as the Happy Times Child Care Center without any further indication of who owns the center. The True Name Certificate requirement exists to provide such people and organizations a way of finding out who actually owns the center in the event any dispute arises (such as non-payment of a bill or injury on the premises).

The Certificate itself is very simple. Generally, it merely asks the name of the owner, the address of the business, the type of business and the address of the owner, if different from the address of the business.

In many states the Certificate will have to be notarized before it can be filed. This simply means that the owner must appear before a notary public, swear that the information in the Certificate is true and sign the Certificate in the presence of the notary.

When the Certificate is filed with the city or town clerk (or other official in some states) it must be accompanied by a small filing fee. The fee is not more than a few dollars anywhere and in some states is only one dollar. Usually the notary public will also charge a fee for notarizing the Certificate and this fee is usually less than five dollars.

If the center is given the name of the owner, for instance, "Jane Jones Child Care Center", a True Name Certificate should still be filed just to be careful although it probably would not be required in many states. The filing of a True Name Certificate is technically not required if the individual owner does not give any name to the center.

The filing of the True Name Certificate is the only legal requirement for the creation of a sole proprietorship. There are other steps, however, which must be taken shortly after creation of the sole proprietorship, if it is to be a properly and lawfully functioning organization. Since these steps are common to all the types of organization which day care centers might use, they are described in chapters on the Operation of the Business. In addition to the steps described in that chapter, the proprietor must, of course, fulfill all requirements of the licensing agency before beginning to operate.

PARTNERSHIPS

In the preceding chapter, the difference between partnerships with only general partners and partnerships which include limited partners were described and the implications of general partnership status versus limited partnership status were outlined. The process with regard to formation of a partnership differs depending on whether the organization is to be composed solely of general partners or is to include one or more limited partners.

General Partnerships

In order to form a general partnership, all that is required in most states is that a True Name Certificate (or "Fictitious Name Registration") be filed with the clerk of the city or town in which the day care center is going to be located. As with the sole proprietorship True Name Certificate discussed above, the partnership True Name Certificate usually must be notarized before it is filed in the clerk's office. It asks for the same information--owner's name and address, location of the center if not at the owner's address, etc.--

as was described above. The filing fee which must accompany the Certificate is usually the same as the fee for sole proprietorships i.e. only a few dollars and in some states only one dollar.

Thus, if Jane Jones and David Drew wish to run the Happy Times Child Center as co-owners with equal responsibility for the organization, they merely file this form and take the other steps described in the chapter on Operation of the Business and they will have fulfilled all the legal requirements for the operation of the center as a general partnership.

However, the co-owners would be well-advised to take an additional step, which is not legally required of them, and prepare what is called a Partnership Agreement. A Partnership Agreement is a document which describes all the facts concerning the way the co-owners intend to establish, operate and, if necessary, terminate the organization. The preparation of such an Agreement is highly advisable because it forces the co-owners to think through their answers to a number of important questions at the very outset of their endeavor.

The typical Partnership Agreement will state what the partners have decided with respect to such issues as:

- How the profits (or losses) will be distributed;
- How much capital and in what form (cash, furniture, etc.) each partner is contributing;
- Who will be responsible for daily management of the center;
- How major decisions will be made (unanimous vote, majority vote, etc.);
- Whether the books will be kept on a cash or accrual basis and on a calendar or fiscal year;
- The manner in which an interest in the partnership may be sold or transferred.

It is advisable to decide these and similar issues at the very beginning for three reasons. First, because it's always better to think through such concerns when there is time for full discussion, reflection and reconsideration rather than making them hurriedly under the pressure of some unforeseen event. Secondly, because partners, even those who know each other well in non-business situations, have a way of seeing such issues from different perspectives and it's unwise to assume your partner will conclude the same way you would on some undiscussed issue. And, thirdly, because partners, even those who are the best of friends, have a way of forgetting what was agreed to long ago, or worse, no longer are agreeable to it once the situation has soured for some reason.

It should be remembered, of course, that while nothing more than the filing of the True Name Certificate is required in order to form the partnership, the partners do not automatically thereafter become entitled to run a day care center. They must still comply with all the other legal requirements regarding licenses, permits, etc., just as any other form of organization running a center would be required to do.

Limited Partnerships

The formation of a limited partnership is a bit more complicated than the formation of a general partnership. There are two required steps in order to form a lawful limited partnership:

- File a True Name Certificate;
- File a Limited Partnership Certificate.

The True Name Certificate for the limited partnership is the same as for the general partnership and is filed in the same manner. The Limited Partnership Certificate is, however, a more complex document and is filed in a different manner.

The filing of a limited partnership certificate is required by almost every state before any type of business, including day care centers, can be operated on a limited partnership basis. In most states the certificate must be filed with the Secretary of State in an office specifically designated to receive it. A filing fee must accompany the certificate and such fees are much higher than those for True Name Certificates; they are typically in the range of $25-$50.

The content of the Limited Partnership Certificate is very similar from state to state although there are some minor variations. In general, the certificate requires the potential partners to provide, usually under oath (i.e. notarized), the following information:

- A description of the nature of the business;
- The amount of cash and the value of all other property contributed by each partner;
- The share of the profits or other compensation which each partner will receive;
- The right, if agreed upon, of partners to receive property other than cash as compensation;
- The period of time during which the partnership will exist;
- The circumstances under which additional partners can join the partnership;
- The order of priority, if any, in which partners will be compensated.

And, of course, the form also inquires about such matters as the full name and residence of each partner, the location of the business (the day care center), the name of the partnership, etc.

As should be apparent, many of the issues which must be resolved in order to file the Limited Partnership Certificate are also issues which are usually addressed in a Partnership Agreement as outlined above. Therefore, any group of people who are considering operating a day care center through the limited partnership form of organization would be well advised to prepare a Partnership Agreement for themselves first and then simply fill out the Limited Partnership Certificate on the basis of the information contained in their agreement.

As with general partnerships, however, there is no requirement that a Partnership Agreement be prepared in order for the partnership to legally exist. On the other hand, each of the points offered above as reasons why general partners should have a Partnership Agreement applies with even more force to a limited partnership because of the extra complexity caused by having partners with differing degrees of commitment and responsibility.

CORPORATIONS

The formation of a corporation for the purpose of running a day care program can be a very simple or a very complex matter; whether it is simple or complex depends on the state in which it is done. The procedures through which corporations are formed are determined entirely by state law and the states vary considerably regarding how complex their required procedures are.

Luckily, in most states, the formation of a day care corporation is relatively simple. There are some states, however--New York is the most extreme--where the formation of a day care corporation can involve a very elaborate and time-consuming process which is very frustrating to go through. And there are several states--with New York again being the most extreme in terms of complexity--where there are several different sub-varieties of corporations through which day care programs can be run with each sub-variety having its own set of formation rules different from each of the others.

In every state there are certain procedural rules which differ depending on whether the day care program you are incorporating is going to be run on a not-for-profit or a profit basis. In most states, this profit/not-for-profit distinction is the basis for four differences: (1) Profit organizations and not-for-profit organizations are created by filling out different official forms and by filing those forms with different state offices, (2) the profit forms will require you to answer questions about stock and stockholders while the not-for-profit forms will inquire about "members" of the organization and their rights, (3) if you are incorporating on a not-for-profit basis, you must carefully limit the statement of organizational purposes and powers in ways that satisfy the concerns of the Internal Revenue Service (since anyone incorporating on a not-for-profit basis presumably intends to seek tax exemption), and (4) usually the filing fee for creating a profit corporation is much greater than for a not-for-profit corporation, frequently as much as five times greater.

Unfortunately, it is beyond the scope of this Handbook to indicate the differences in the corporation formation process from state to state in any detailed way. What this section will do is to summarize the matters which are common to almost every state's requirements. In a large number of states, these will be the only requirements; in a few there will be many others as well, but those listed here should be the core of the process.

Basically, there are four major steps involved in the incorporation of a day care program:

- Preparation of Articles of Incorporation;

- Preparation of By-Laws;
- Conduct of initial Incorporator's Meeting;
- Filing of Articles and other documents.

In some states, such as New York, by-laws may not be required for incorporation. However, they are always required by IRS as a pre-condition to tax exemption even if the state doesn't require them for incorporation.

If you are creating a not-for-profit organization, once these steps are completed and you have received official confirmation of corporate status, you should file an application for tax-exemption. But since the process of getting a tax-exemption is completely separate from (and subsequent to) the process of getting incorporated, it will not be discussed here.

Articles of Incorporation

Every state requires the preparation of Articles of Incorporation (sometimes called by some other name such as Certificate of Incorporation or Articles of Organization) as a principal step in the incorporation process and in most states it is the first step. Each state issues, usually free, an official form for an organization's Articles of Incorporation and this form is usually obtained from the same state office where it is filed after being filled out (usually the Secretary of State's Office or Department of Corporations). The Articles form will contain a number of questions which must be answered by the "incorporator(s)", which is the name given to the person(s) who sign the form and thus are the organization's legal creators. (See page 39 regarding incorporators.)

The questions on the Articles form primarily concern three matters: the purposes for which the organization is being formed, the powers which the organization will have, and the members of the organization. It is best to state the purpose of the organization, simply and briefly. As pointed out earlier, if the day care program is intended to be tax-exempt and thus not-for-profit incorporation articles are being filed, it is very important to couch the purposes answers in language which is acceptable to the Internal Revenue Service--"educational", "charitable", etc. To be safe, it is usually a good idea to include a sentence restricting the organization's purposes "to those permitted under section 501(c) (3) of the Internal Revenue Code of 1954 or its successor sections in subsequent revenue codes".

With regard to the powers of the organization questions, a day care program being incorporated on a profit basis will want to claim all powers normally granted to corporations under state law. This can be accomplished either by a simple sentence making such a claim or, to be more cautious, actually listing all the powers (purchase property, make and receive loans, form pension plans, etc.). The list can probably be obtained from the same office where the Articles form is obtained. For a program being incorporated on a not-for-profit basis and intended to be tax-exempt, certain powers normally granted to corporations may not be claimed because they would render the organization ineligible for tax-exemption. This problem can be dealt with in two ways: (1) by simply claiming "all those powers permitted to be exercised by not-for-profit corporations in the state of (your state) which are also permitted to be exercised by organizations exempt from taxation under section 501(c) (3) of the Internal Revenue Code of 1954 or its successor sections in subsequent revenue codes". (2) The alternative is to list specifically all the powers normally available and then follow the list with a statement restricting the organization to the use of those powers permitted under section 501(c) (3).

With regard to <u>members of the organization</u> (in a not-for-profit center) or shareholders (in a profit center), the questions usually relate to rights and duties which these individuals have. Some states have abolished outright the requirement that not-for-profit corporations have members and most states permit the people who serve on the Board of Directors to be the members (they simply "switch hats" at meetings depending on the kind of action they are taking). To avoid unnecessary complexities and additional paperwork, it may be desirable to avoid having members in states where that is permissible. The additional paperwork is created by the fact that the members and the Directors are required to hold separate meetings, maintain separate records, file separate reports with state agencies, etc. On the other hand, in some situations, there may be reasons internal to your group why it is desirable to have both members and a Board of Directors; this will most often be the case where a large number of people are involved in the day care program. Typically, in such a situation, the Board of Directors will be primarily concerned with financial matters and regulatory agency issues while the members, who usually are all parents, are more concerned with curriculum and related quality of care issues.

The Articles form will also inquire about a number of other less complicated matters including the names of the initial Board of Directors, the names of the initial officers, the date selected for the Annual Meeting, and the date selected for the end of the fiscal year.

By-Laws

In most states, formal By-Laws are required to be prepared as part of the incorporation process. In those few states where they are not required, it is still advisable to prepare them because the By-Laws constitute the basic rules under which the organization will conduct its affairs and they set out the manner in which orderly decision-making will take place and the manner in which smooth transfers of power can be effected. Essentially, an organization's By-Laws are its rules for determining four things: (1) who has the power (2) to make which kinds of decisions and (3) when these decisions can be made and (4) how or in what manner they must be made.

Usually, the state simply requires that an organization have By-Laws; it doesn't prescribe what can go in them. In a limited sense it does control the content of the By-Laws, however, by prohibiting them from containing anything contrary to the contents of the Articles of Incorporation. In addition, the Internal Revenue Service will review the By-Laws of any organization which applies for tax-exemption so any day care program intending to be exempt must be careful not to put matters in the By-Laws (additional organizational purposes and powers, for instance) which might jeopardize eligibility for exemption. With these two exceptions, the incorporators are generally free to put whatever they like in the By-Laws.

Incorporators' Meeting

Every state requires that the Articles of Incorporation be signed by an incorporator and some states require several, usually three, incorporators. In most states any person who is over the age of majority may act as an incorporator; in some states, however, restrictions are placed on whether persons with criminal records may act as incorporators of not-for-profit organizations.

It is the duty of the incorporators to take all the official acts required to bring the corporation into legal existence. These acts include preparation of the Articles of Incorporation, preparation of the By-Laws, and a series of acts which are to be taken at what is called the <u>initial meeting</u> of incorporators (which is usually the only meeting they are legally required to hold). At the initial meeting, the incorporators must, by formal vote, take the following actions: (1) adopt the name of the corporation, (2) approve the Articles of Incorporation, (3) approve the By-Laws, (4) elect the initial officers and Board of Directors (who will serve only until the first meeting of members), (5) authorize the issuance of stock, if the Articles are for incorporation on a profit basis, and (6) vote to file the Articles of Incorporation with the appropriate state office. Formal "minutes" of these actions should also be taken. These "minutes" can simply be a piece of paper on which all the votes taken at the meeting are listed, together with the names of those who voted (the incorporators). The minutes should be dated and signed by each incorporator.

Once the state approves incorporation and a corporate charter (it may be called something else) is issued, the status of incorporator goes out of existence. The persons who served as incorporators no longer have any duties, responsibilities or powers regarding the organization. From the moment of approval onward, all authority in the organization lies with its members, if it has any, and with its Board of Directors.

Filing the Articles

In most states the Articles of Incorporation are filed with the same state office from which the blank articles form was obtained. "Filing", in most cases, simply means taking the document to the office and handing it over to a clerk, together with a check. In a few states, such as New York, the Articles must be approved by a local court before they can be filed.

Usually, the incorporator will be required to file the By-Laws along with the Articles of Incorporation and often will also be required to file the "Minutes" of the initial meeting of incorporators as well.

A check for the "filing fee" must accompany these documents. The fee varies from state to state but generally is in the range of $25-$50 for a not-for-profit corporation and a minimum of $100 for a profit corporation. Cash will generally not be accepted, but a money order will do if you do not have a personal check. Once the documents are filed and the fee paid, you simply wait for the written notice that they have been approved and the charter has been issued. The duration of this wait varies greatly from state to state and even within a state it often varies by county and by season of the year. It can take anywhere from ten days to four or five months.

OPERATING THE PROGRAM: THINGS WHICH YOU MUST DO

EMPLOYER IDENTIFICATION NUMBER

STATE UNEMPLOYMENT INSURANCE

SOCIAL SECURITY

WITHHOLDING EXEMPTION CERTIFICATES

PERIODIC TAX RETURNS

ANNUAL TAX RETURNS

ANNUAL STATE REPORTS

Chapter III

OPERATING THE PROGRAM: THINGS WHICH YOU MUST DO

Since the operation of a day care program is, as a matter of law, the operation of a business, there are a number of legal requirements applicable to all businesses which you must fulfill in order to operate your program in a lawful manner. Remember that there are also legal requirements regarding such matters as licensing and permits, but since these issues are beyond the scope of this Handbook they aren't discussed here.

EMPLOYER IDENTIFICATION NUMBER

Every organization, no matter how small, which employs people on a regular salaried basis is required to obtain a federal Employer Identification Number. This includes all forms of organization--sole proprietors, partnerships and corporations. In addition, a not-for-profit corporation is required to obtain an Employer Identification Number even if it doesn't have any employees. Without one, it cannot file an application for tax exemption or file the required annual information returns. Thus, if you plan to operate your day care program as a not-for-profit corporation but don't plan to actually begin running the program until some time in the future considerably after receiving official notice of incorporation, you must still acquire the number.

An Employer Identification Number is acquired by filing an application with the Internal Revenue Service. The application is IRS Form SS-4 which can be obtained from any local IRS office, the addresses of which are listed in the telephone book under the heading "U.S. Government". The form is very short, about the size of two postcards, and asks about a dozen questions, such as address of the organization, types of activities it engages in, etc. The form can be filed by mail and there is no filing fee.

STATE UNEMPLOYMENT INSURANCE

As soon as an organization with any employees begins operations, it is required by most states to register with the state unemployment insurance office, which is usually called something like the Department of Employment Security or Department of Unemployment Compensation. Registration is usually accomplished by filling out, and returning by mail, a questionnaire about your activities, your employees and your organization's tax status. Normally, there is no registration fee.

If you are running a day care program as a not-for-profit corporation, you will have, in most states, an option to choose between two alternative methods of participating in the unemployment compensation system. These two alternatives can be called the "actual costs" method and the "contributions" method. Under the actual costs method, you do not pay any unemployment tax or make any other payment until a former employee goes on unemployment. Once a former employee begins collecting unemployment compensation, your organization is then obligated to pay the state unemployment office the actual cost of the amount of benefits which it has paid out to the employee. If no former employee ever goes on unemployment, you never have to pay anything.

Under the contributions method, you regularly pay the state's unemployment tax for employers at the reduced rate established for not-for-profit corporations. This rate is based on the total amount of wages you pay and in most places is no more than 3 percent of total wages. Under this system, you make regular tax payments, usually quarterly, at the established percentage rate regardless of whether any former employees have gone on unemployment compensation or not.

In most situations, the contributions method will be cheaper in the long run if you expect to be in existence for a while and anticipate that from time to time former employees will go on unemployment. If you expect to be in existence for only a short time or if, for some reason, you feel confident that no former employee will leave your program and go on unemployment, the actual costs method will be cheaper since its costs are zero if no claims are ever made.

SOCIAL SECURITY

Any day care program, except for those operated through tax-exempt corporations, which has regularly salaried employees is required to participate in the Social Security system through payment of the Federal Insurance Contributions Act (FICA) tax. The FICA tax is paid partially by the employer and partially by the employee with each "contributing" equal amounts. The amount of the tax changes frequently (always upward) and currently is set at 5.85 percent of the employee's first $16,500 of salary. The employee's "contributions" are made through payroll deductions while the employer deposits quarterly the amount of those deductions plus an equivalent amount from the employer's own funds.

Since Social Security is a federal tax, a day care program which has received a federal tax-exemption is not required to participate in the Social Security system if it doesn't wish to. Unfortunately, the legal requirements regarding participation in Social Security by tax-exempt organizations are undergoing tremendous change and, as of the date of writing of this Handbook, cannot be stated with any finality. In October, 1976 Congress enacted legislation which made many radical changes in this area of law and the Internal Revenue Service has not yet announced exactly how it is going to implement them. Consequently, it would be advisable for any day care program operated through a tax-exempt corporation to contact the local District Office of the Internal Revenue Service to inquire about procedures regarding Social Security.

WITHHOLDING EXEMPTION CERTIFICATES

Every organization which has employees is required to obtain each employee's signature on a withholding exemption certificate. These certificates, which are called IRS Forms W-4, are the basis for determining how much to withhold from each employee's paycheck for federal, state and city (if any) income taxes. Each new employee should fill out the form, indicating marital status and number of dependents, before receiving the first paycheck. Whenever marital status or number of dependents changes or whenever, for personal reasons, the employee wants a larger amount to be withheld from each paycheck, a new form should be filled out and signed. The forms are obtained from the Internal Revenue Service and, once filled out, should be retained in the day care program's official financial records.

PERIODIC TAX RETURNS

Employers are required to file quarterly federal tax returns on April 30, July 31, October 31 and January 31 of each year. The return, which is called IRS Form 941, is filed by mailing to the Regional IRS Service Center whose address will be listed on the instructions which accompany the return. If the return is not filed on time, IRS will assess a penalty against you of 5 percent of the total withheld income taxes per month. Since IRS assesses this penalty for late filing of the form and not for late payment of the taxes, you should always file the form on time even if your organization doesn't have the cash to pay the tax due. (Attach a note saying the payment will be made later.)

ANNUAL TAX RETURNS

Every organization is required to file an annual federal tax return regardless of whether it made a "profit" or not, is tax-exempt or not, even regardless of whether it was actually operating during the year so long as it was legally in existence during the year.

A day care program which is operated as a tax-exempt corporation will be required to file IRS Form 990, the "Return of Organization Exempt From Taxation". This return must be filed no later than four months and 15 days after the end of the program's fiscal year. If the program has adopted June 30 as the end of the fiscal year, as is traditional, the form must be filed by November 15 each year.

For a day care program operated as a partnership, the partners must file IRS Form 1065 by April 15 of each year. If the partners have sources of earned income other than the day care program, then they must report the day care program income on Part III of Schedule E - Form 1040 by April 15 of each year. For a day care program operated as a sole proprietorship, the person operating the program must file Schedule C - Form 1040 by April 15 each year.

All programs, no matter what their organizational type, are required to file Form 1099 each year if, in the course of the year, the program paid more than $600 in fees or any other compensation to any individual who was not an employee (for instance, an accountant or a plumber). The purpose of this form is to report to IRS that you paid fees to someone without withholding any taxes. This form comes in triplicate; the day care program keeps Copy C, Copy B goes to the person who received the money, and Copy A goes to IRS.

ANNUAL STATE REPORTS

If the day care program is a not-for-profit corporation, it will, in most states, be subject to several requirements concerning annual reports to state agencies. Almost every state requires an annual Financial Report. Usually this report is filed with the same state agency which processes Articles of Incorporation. Often there is a penalty, which may even involve revocation of corporate status, for failure to file the report. In some states, the report must be signed by an independent auditor if the program had income over a certain amount during the year.

Many states require the filing of an annual Informational Report, usually in addition to the Financial Report. The Informational Report requires you to indicate the names and addresses of current members of the Board of Directors, names and addresses of current officers, sources of organizational income, etc. In states which require both Informational and Financial Reports, they are usually filed with different state agencies and frequently are due on different dates. Generally, small filing fees in the range of $5-$10 must accompany the reports.

OPERATING THE PROGRAM II: THINGS WHICH YOU SHOULD DO

SEPARATE BANK ACCOUNT

PERSONNEL POLICY STATEMENT

AUDITORS

INSURANCE

CONTRACTS FILE

INDEMNIFICATION

TAX EXEMPTION

- Advantages and Disadvantages
- Categories of Exemption
- Source of Exempt Status
- Period of Exemption
- "Sister Organizations"

Chapter IV

OPERATING THE PROGRAM II: THINGS WHICH YOU SHOULD DO

There are a number of actions which virtually every provider of day care services should consider taking at the very beginning of operations even though, unlike the matters outlined in the previous chapter, there is, in most instances, no legal requirement that these actions be taken. These actions are recommended either because they help structure the organizational affairs of the program in a sensible manner, or because they help protect against potential sources of liability, or for both reasons.

SEPARATE BANK ACCOUNT

With the possible exception of the very smallest sole proprietorship efforts, every day care program operator should open a separate bank account in the program's name as soon as funds are available to open it. In most cases, this should be before the program starts receiving fees for services. A "separate" bank account means one which is not the personal account of the individual operator or operators.

A separate bank account is legally required for incorporated programs. It is not required for programs operated as sole proprietorships or, in most states, as partnerships--but it is highly advisable. The principal reason for the desirability of a separate bank account is as a protection for the operator(s) in the event any questions of financial irregularities are ever raised by anyone. A second, and in many cases equally important, reason is that some funding sources insist on a separate account as a condition of providing funds. It is, of course, always wise to maintain a separate account when receiving funds from a governmental agency, even if the agency doesn't actually require it.

For an incorporated program, a separate account is opened by having the Board of Directors vote to approve a Banking Resolution. A pre-printed form for this resolution can be obtained free from most banks. In many states, a partnership must also open an account with a Banking Resolution signed by each partner. A sole proprietor simply opens an account the way she or he would as an individual but opens it in the program name rather than her/his own name.

The Banking Resolution will indicate who is authorized to write checks or otherwise withdraw money from the program's account. Many incorporated programs take the precaution of requiring that all checks carry two signatures: one from an employee (usually the Director) and one from a Board member or officer. The people who are named will be asked by the bank to sign several Signature Cards on which they indicate their title (in the program), home address, etc. The bank will honor checks and other items only if signed by authorized people, and the bank will continue to honor them until it is given notice in writing not to. Usually, this notice is accomplished by filing new signature cards without the name of the person who is no longer authorized. For an incorporated program, a new Banking Resolution must also be filed. Until these steps are taken, a person originally authorized is still legally permitted to sign checks, even if the person has been fired from the program's staff.

PERSONNEL POLICY STATEMENT

In any program with more than three or four employees, it is desirable to develop a written personnel policy statement. Such a statement is often requested by funding sources, both governmental and private, and in larger programs is almost always requested by auditors. There appears to be a trend toward requests for it by licensing authorities as well. In addition to these "external" (to the program) reasons, it is very useful in the smooth operation of a large program if all the people working in it can be informed at the outset what the basic rights and expectations are with regard to matters like paid holidays, vacation accrual, sick pay, salary advances, changes in working hours and other similar things which always seem to arise more often than program operators ever expect.

The personnel policy doesn't need to be elaborate or attempt to cover every conceivable detail. It is much more important that it be clear and that the rules it sets out be fair. It is perfectly appropriate for a relatively large amount of discretion to be granted to the Executive Director but, on the other hand, not everything should be left to the decision of the Director on a case-by-case basis as this is guaranteed to result in difficulties. The best idea is to set out a few basic principles according to which the Director will make decisions.

Particularly in larger programs, it is important that the personnel policy statement indicate who on the program staff has access to which kinds of records. This is important for reasons of confidentiality and to guard against invasion of privacy.

AUDITORS

An auditor is a Certified Public Accountant (C.P.A.) who reviews the books and all other financial records of an organization at the end of the year and prepares "financial sheets" summarizing the income and expenses of the organization after which she or he "certifies" in what is called the Accountant's Report that everything is in proper order. (Or declines to do so if everything isn't!) The review process which the C.P.A. goes through is called "the audit". The audit is conducted at the end of the fiscal year which may or may not be the calendar year (you pick the date), but generally is not. Most organizations end their fiscal year on June 30, although there will doubtless be a trend to switch to September 30 since the Federal government switched from a June 30 to a September 30 fiscal year in 1976.

The auditor is a person, or more often a firm, whom you hire solely for the purpose of conducting an annual audit. Your staff bookkeeper, or accountant if you have one, cannot perform the audit. This is because audits are required to be "independent" and someone on the program's staff is obviously not independent of the program.

In most states, all not-for-profit corporations are required to have a certified independent audit conducted annually if their income is above a certain level. This income level varies, but $5000 is a typical level. Since most incorporated day care programs take in more than $5000 in total income (income, not profit) in the course of a year, most are subject to the audit requirement. Sole proprietorships and partnerships are not required by law to have annual independent audits conducted, but they may be required by funding sources to submit audited financial statements. Where sizeable amounts of money are involved, it is always wise, as a self-protection measure, to have audits performed, even if there is no requirement that one be done.

It is advantageous to hire auditors long in advance of the time the audit is to be done. This will enable the auditor to consult early in the year with your bookkeeper about how financial matters are handled. There are two advantages to this practice. First, potential problems can be ironed out early which will save you money since auditors bill at fairly high hourly and daily rates. Second, by consulting in advance with the bookkeeper about how various matters should be handled, the auditor indirectly gets committed, in an informal way, to approving your bookkeeping system and thereby you avoid receiving any negative comments in the final audit report.

After you have spoken with several C.P.A.'s or C.P.A. firms about conducting the audit and you have selected the one you want, you should ask for an <u>Engagement Letter</u>. This letter, which constitutes a contract between your program and the auditor, is a document in which the auditors describe exactly what they will do, when they will do it, what their fee will be, and what, if anything, they want you to do to prepare for the audit. Be careful to ensure that the <u>cost of printing</u> the audit report is included in the fee. Many a small program has negotiated what it considered to be an acceptable fee only to discover, after the audit was completed, that the printing fee, which can be several hundred dollars, wasn't included.

INSURANCE

Because of the importance of insurance, it is discussed separately in the next chapter. However, despite its importance, it doesn't differ in nature from the other matters outlined here; like them, it is something which you should give very serious consideration to obtaining but, in most situations, it is not something which you are required to obtain.

CONTRACTS FILE

Because of the confusion often surrounding contracts, they are discussed separately in the next chapter. But it should be pointed out here that it would be very useful for day care programs of any size to adopt the practice of maintaining a contracts file. This is a file kept separate from the other organizational and financial records of the program and which contains the original of every contract involving the program which is currently in force. It should also include a brief internal memo summarizing the terms of any agreement currently in force which the program has entered into without any written contract document being involved. Every variety of contract including those for supplies, for food, staff employment contracts, leases, etc., should be kept in this file. If you use a purchase order system for items such as food, copies of the purchase orders should be kept in the file.

There are three reasons why the maintenance of a contract file is desirable. First, it makes it more likely that no important obligation will be forgotten or the documents involving it be lost. Second, it makes your preparation for the annual audit or for any other type of financial review of your program much easier. And, third, it facilitates smooth transitions when personnel changes take place. It is the surest way of guarding against the confusion and unnecessary problems often caused by the departure of a bookkeeper or Executive Director on short notice.

INDEMNIFICATION

Indemnification is the legal word for protecting someone against having to bear personally the financial consequences of some potential liability. With regard to most forms of potential liability, the principal method of achieving such protection is through the purchase of insurance. With regard to one important area of potential liability, however--that of the officers and members of the Board of Directors of a day care program organized as a not-for-profit corporation--insurance is not generally available.

It is possible, however, to protect these individuals from ever being in a position of having to pay from their personal funds for some wrong done by the organization. This is accomplished by having the Board of Directors formally vote an Indemnification Resolution, which in some states would have to be approved at the Annual Meeting of Members. The Indemnification Resolution should be phrased in some way similar to the following: "No Office or Director will ever have to pay any money as a consequence of any action or inaction of the organization unless the action or inaction was a direct result of gross negligence of duty on the part of the Office or Director, and if any Officer or Director is ever held liable for any payment for any reason not involving gross negligence, such payment will be made from the funds of the organization, either directly or as reimbursement to the Officer or Director."

TAX EXEMPTION

As is indicated in several places in this Handbook, tax exemption does not "come automatically" along with not-for-profit corporation status, and a day care program organized as a not-for-profit corporation is not required to file an application for federal tax exemption. However, it is clearly very advantageous for an incorporated program to seek tax-exempt status, and it is doubtful whether there are any circumstances under which it would be sensible to incorporate a program on a not-for-profit basis without also applying for both federal and state tax exemption.

Advantages and Disadvantages of Tax-Exemption

While "tax-exemption" sounds like something which is indisputably desirable, it is useful to know precisely what its various advantages--and several disadvantages--are before plunging into an effort to make a center tax exempt. The most important advantages of securing tax-exemption have been referred to in the last few pages but a list of all the principal advantages would include:

- No federal or state income taxes have to be paid;
- No state sales taxes have to be paid;
- Contributions to the center are tax-deductible for the organization (such as a foundation) or the individual who makes the contribution;
- The likelihood of being successful at getting grant funds is increased;
- The center's employees can choose not to pay Social Security (FICA) taxes;
- The Federal Unemployment Tax does not have to be paid;
- State unemployment taxes do not have to be paid, in most states, so long as no employee makes a claim;
- The center can use space in a church, community center or any other tax-exempt organization without jeopardizing that organization's exempt status;

- The center will be eligible for the lowest postage rates;
- Much of the paperwork involved in a corporation which is not tax-exempt is avoided.

Like everything else in life, however, tax exemption has some disadvantages as well. The principal disadvantages include:

- More time and expense will be taken up by the initial activities and paperwork required to establish the center than if it were operated in any other manner;
- Annual audits of the center's books and other financial records will probably be required;
- The auditors who make annual reviews of the center's books will tend to be more strict;
- The center will be subject to the scrutiny of a number of state regulatory agencies merely because of its exemption;
- Whenever the center goes out of business, any of its assets remaining after payment of debts will have to be given away to some other tax-exempt organization--the organizers of the center will not be able to keep the assets or any proceeds from the sale of them.

Categories of Exemption

The United States Internal Revenue Code contains a dozen and a half categories of tax-exempt organizations. Day care centers are eligible for exemption under two of those categories. The categories are usually referred to by the numbered sections of the Revenue Code in which they appear; the two sections under which day care centers are eligible are 501(c) (3) and 501(c) (4). Organizations which apply for exemption under section 501(c) (4) are called "social welfare organizations". Organizations which apply under section 501(c) (3) must be "charitable, educational, literary, religious or scientific". A day care center applying under 501(c) (3) would claim to be educational or charitable or both depending on the facts about the particular center's clientele and sources of income.

Until recently, it has been easier usually for a center applying under 501(c) (3) to be successful with its application if it applied under the "charitable" heading rather than the "education" one. There are some indications that this is changing, but there really is no nationwide uniformity since the decision about whether to grant the application is generally made in the local district office of IRS.

There are several major differences between what an organization which is exempt under 501(c) (3) can do and what one which is exempt under 501 (c) (4) can do. Only one of these differences is of any real concern to day care centers and that one can be of considerable importance. Contributions (whether made by an individual or an organization) to the day care center are tax-deductible by the contributor if the center is classified as 501(c) (3) and they are not deductible if the center is classified as 501(c) (4). Exemption under 501(c) (3) is clearly preferable for a day care center. A center should apply for 501(c) (4) status only if it is unsuccessful, after initial application and appeal, at getting (c) (3) status.

Source of Exempt Status

As indicated above, the United States Internal Revenue Service District Office is the source to which a center must apply for a federal tax-exemption. If the District Office does not grant the exemption, the center can appeal to the IRS National Office, Exempt Organizations Branch, in Washington, D.C. In most states, the state government will have a Department of Corporations or Department of Taxation to which application for exemption from state taxes is addressed. In some states, the application is filed with the office of the Secretary of State.

In some states it may be necessary to file two different applications, one for exemption from income taxes and another for exemption from state sales taxes. Many currently operating day care centers are unaware that they are eligible for exemption from state sales taxes and have been unnecessarily paying sales taxes on everything they buy, from crayons to chairs to buses.

Once a state sales tax exemption has been granted, a certificate will be issued to the center containing an "Exempt Purchaser Number". Thereafter, employees purchasing things for the center need only supply the seller with that number and no sales tax will be charged. (Some states have a requirement that the seller be shown a copy of the certificate but this isn't often enforced.)

The application for federal exemption should be filed before the application for state exemption. In many states no action will be taken on the state application until the federal application has been granted. (New York is a notable exception to this rule.) The federal application, in turn, will not be acted on until after the center has filed its original incorporation papers. In most states these papers are filed with a state agency such as the Secretary of State's Office; in a few, it is done in the local court; in several, filings must be made both in court and in an agency. Thus, the normal process for someone wishing to form a day care center as a not-for-profit, tax-exempt corporation has three steps which should be taken in this order:

1. File Articles of Incorporation with appropriate state authority.
2. File Application for Federal Tax Exemption (Form 1023) with Internal Revenue Service District Office.
3. File Application for Exemption from State Sales Tax and Income Tax, if separate applications are needed, with appropriate state authority.

A filing fee will be charged when the Articles of Incorporation are submitted. The fee varies from state to state but is usually in the range of $10 - $50. There is no fee for filing the federal exemption application. Some states charge fees for filing the state tax exemption and others do not; the fees are very minimal, usually considerably less than what the state charges to file Articles of Incorporation.

Period of Exemption

It will take anywhere from two to six months, depending on the area of the country, between the time the center's application is filed with the Internal Revenue Service and the time IRS notifies you about whether the application has been granted or denied. IRS calls this notification process "the issuance of a Determination Letter".

If the Determination Letter states that the center's application has been granted ("allowed" in IRS language), it will also state the date as of which the exemption is effective. Under the "rule of relation back", the Determination Letter will normally indicate that the effective date is the date on which the corporation was officially organized. (Thus, the exemption, which is allowed on the date the Determination Letter is issued, "relates back" to the date the center was incorporated.)

However, this rule applies only if you file the Application for Tax Exemption within 15 months of the date your organization was incorporated. If you file later than that, the exemption will not "relate back"; it will be effective as of the date of filing the application. The effect of this rule is that the center is considered to have been always tax-exempt from the first day it was formed even if that day was several years before the center ever received a favorable Determination Letter. For example, if your center was incorporated on January 1, 1975 and you filed the Application for Tax Exemption on January 1, 1976 and on January 1, 1977 IRS issued the Determination Letter granting exempt status, the effective date of your exemption would be January 1, 1975. The "relation back" effect is very important to day care centers which hope to get funds from foundations and other organizations or individuals for whom the tax deductibility of contributions to the center are important.

"Sister Organizations"

It is possible for a day care center, or a network of centers, to be operated through more than one corporation or other legal organization simultaneously. In the case of large centers or groups of centers this possibility can have some attractive aspects.

For example, it is possible for a center to be operated through a combination of a not-for-profit, tax-exempt corporation and a profit, taxable corporation. The second could be a subsidiary of or a "sister organization" to the first. A situation where it might be desirable to do this would be where the center's original basic organization, which was not-for-profit and tax-exempt, was precluded by the terms of its grants and contracts from purchasing certain items, for example, office equipment and furniture and was only permitted to rent such items. (This is a typical provision of many grants.) Rather than rent the items from merchants, thereby incurring over time larger costs than purchase would entail and merely enriching the merchants, the center could form a subsidiary profit corporation which could purchase the needed items and it could rent them to the center. In addition to the obvious financial advantages of such an arrangement, it also has the spin-off effect of enhancing community organization through building self-sustaining, community-run businesses.

The possible combinations of and implications of running day care centers and networks through such multiple-organization structures are too complex to be treated in this Handbook, but organizers of centers which are either reasonably large or are operated under various grant restrictions should certainly consider these options.

OPERATING THE PROGRAM III: INSURANCE AND CONTRACTS

INSURANCE POLICIES

Liability Insurance

Automobile Insurance

Workmen's Compensation.

Fire and Theft Insurance

Fidelity Bonds

Health Insurance

CONTRACTS

Chapter V

OPERATING THE PROGRAM III: INSURANCE AND CONTRACTS

Insurance and contracts seem to be troublesome areas for day care programs. There probably is no important aspect of the operation of a day care program that is more likely to be overlooked than the need for adequate insurance. An insurance policy is actually just a contract--between you or your program and the insurance company--but since it is a very special kind of contract and possibly the most important contract a program will enter into, we'll deal with it separately from other contracts.

INSURANCE POLICIES

When thinking about insurance there are two principal things to focus on:

- Degree of potential risk;
- Amount of potential loss.

"Degree of potential risk" means the likelihood of some event happening, such as a child falling off a swing.

"Amount of potential loss" means the amount of financial liability which you might incur if that event did happen. The determination of whether you need a particular kind of insurance, and if so how much you need, should be made by considering these two factors together. For instance, you should think about the likelihood of a particular class of risks, such as children being accidentally injured on the program's premises, and the amounts of money you might be required to pay as a result of those risks occuring, such as doctor's bills, hospital bills, etc., and then make the decision.

With regard to a class of risks where the likelihood is high and the potential financial consequences are also high, the need for a substantial amount of insurance should be obvious. With regard to a class of risks where likelihood is relatively low and the financial consequences relatively small (an example in many areas might be thefts), it might be reasonable to conclude that insurance coverage wasn't necessary, given an already strained budget.

The most difficult decisions, naturally, involve situations where, after considering both the potential risks and the potential loss, you conclude that one of these factors is quite high and the other quite small. A reasonably cautious outlook might be to forego insurance where the risk is high but the loss is low, but to purchase insurance where the potential loss is high even though the risk is low. While this may seem counter to your initial instinct, it makes financial sense if your assessment of the two factors is accurate and if the program's finances could bear the costs of relatively small liabilities. Ultimately, the determination in these situations rests on two issues: first, how much of a hardship would it be to pay the insurance premiums (fees) and, second, what is the likelihood that, in the long run, the insurance premiums would cost you more than paying directly for the consequences of the loss.

The act of buying insurance really involves a trade-off: you are swapping what you consider to be a large uncertainty (the degree of risk plus size of loss) for a certainty which you expect to be smaller (the premium).

There is one major alternative to insurance as a method of protecting yourself. This alternative exists in many forms, all of which constitute transferring the risk, and therefore the liability, to someone else. Some common examples of this process would be to run the program in a leased building rather than in one you own, to purchase services such as janitorial work under a contract rather than hiring an employee to perform them, to lease vehicles in which children are transported rather than buying them or reimbursing employees for use of their own vehicles, etc.

This method of thinking about insurance should be used with regard to each of the major categories of insurance except in those limited instances where you are required, either by a licensing authority, a state law, or a funding source, to carry a specified amount of a certain type of insurance.

Liability Insurance

The most important type of insurance, the type which any day care program operator should think very long and hard about before deciding to go without, is liability insurance. Liability insurance is what protects you from the consequences of accidents which occur on your premises. In legal terms, liability insurance is what protects you against the consequences of "negligence". Without trying to define negligence, as a general rule you can assume that virtually any kind of accident which occurs on your premises is quite likely to be considered to have occurred as a result of negligence, if the injured party should press the issue. Remember that day care programs are subject to the legal rules applicable to businesses and in our legal system there is almost a presumption of negligence regarding accidents which occur on business premises or as a result of business operations.

Most liability insurance policies cover four types of risks:

- Bodily injury which occurs accidentally;
- Damage to the property of another person which occurs accidently;
- Expenses of immediate medical relief at the time of the accident;
- The legal costs of defending against suits by injured parties.

A policy which covers all four of these is called a general liability policy. A general liability policy is almost always expressed in terms of limits per person and per accident on amounts the insurance company will pay. For instance, the policy might be limited to $25,000 per person/$100,000 per accident.

The dollar limits per person and per accident which you select when you purchase the insurance are a very large factor in determining what the premium (cost) of the insurance will be. Most people do not realize, however, that very substantial increases in the dollar limit do not carry with them proportional increases in the premium. For instance, under a typical policy, increasing the limits from $5,000/$10,000 to $100,000/$300,000 represents a 2,000 percent increase in coverage, but the increase in premium to get this extra coverage would be less than 100 percent, so you get twenty times the protection for less than twice the cost. Obviously, this is an area in which it is very easy to be "pennywise and pound foolish".

Automobile Insurance

Automobile insurance is a variety of liability insurance--with a personal property protection component added on--but it is treated by the insurance industry as a completely separate matter from other sources of liability. Virtually every state requires the owner of a motor vehicle to purchase liability insurance. As with the general liability insurance discussed above, the premium on automobile insurance is heavily dependent on the per person/per accident coverage limits which you select. Any day care program which owns vehicles in which children are transported or which permits its employees to use their own vehicles to transport children is being very foolish if it doesn't acquire a significant amount of insurance. There probably is no situation in which the degree of potential risk and amount of potential loss are greater.

In the typical program, there are no program-owned vehicles, but program staff people are permitted (or even requested or required) to use their own vehicles to transport children. From strictly financial and legal viewpoints, this is unwise and virtually any alternative--taxis, the children's neighbors, etc.--would be preferable. However, the reality is that it often seems necessary. One relatively simple way of accommodating that reality is for the program to pay to its staff people who use their cars whatever it costs them to increase their personal automobile insurance to a sufficiently high level to cover the program's possible liability. For instance, if the staff person normally carries only $10,000/$20,000 in auto insurance, the program might pay the additional premium needed to raise that to $50,000/$100,000.

Workmen's Compensation

Like automobile insurance, workmen's compensation is another special category of liability insurance which is treated separately from "general" liability insurance. Also like automobile insurance, workmen's compensation insurance in many states is required, rather than optional. Most state laws do, however, contain exemptions from the requirement for certain classes of employers. A typical exemption which is applicable to many day care programs is the exemption for organizations with four or fewer full-time employees.

Workmen's compensation insurance is intended to protect against the consequences of injuries sustained by employees either on the program's premises or while performing duties for the program off the premises. In many states employees have the choice of being reimbursed for injuries through workmen's compensation benefits or of suing the employer the way anyone who was injured as a result of another's negligence might do. A program which wants to protect itself against both alternatives needs what is called a "workmen's compensation and employer's liability policy". Under such a policy, the insurance company pays 100 percent of all workmen's compensation benefits which are required by state law as well as any sums which the program might be held liable for in any court action by the injured employee. In a few states, such as New York, it is possible to get a comparatively cheap policy through an agency of the state itself, usually called something like the State Insurance Fund.

State laws determine the kind and amount of benefit payments available to employees covered by workmen's compensation. Neither the employer-program nor the insurance company can alter these amounts. The premium which the day care program must pay for a workmen's compensation and employer's liability policy is determined by the number of people on the payroll.

Fire and Theft Insurance

Insurance against losses from fire and theft can be purchased either together as a combined package or under separate policies. Normally, the more kinds of insurance you buy at one time from the same agent, the cheaper the whole package is. This will not necessarily be the case, however, for programs located in very large cities which wish to purchase theft insurance. Theft insurance can be exceptionally expensive and in some areas is, for all practical purposes, not obtainable.

Because of this fact, the U.S. Government has recently started the Federal Crime Insurance program. Federal Crime Insurance is sold only in high-crime urban areas and the p[illegible]iums involved are very small compared to rates charged by private insurance [illegible]anies. It is sold through regular insurance agents who are all required by the government to offer this insurance. They are also required to inform you of its existence if you apply for more expensive private insurance. A few states have adopted state versions of Federal Crime Insurance which in some instances have even lower premium rates than the federal rates. One example of such a program is in Massachusetts which operates an urban crime insurance program called the Massachusetts Fair Plan. As with the federal insurance, these state insurance policies are usually handled by regular insurance agents.

Fire insurance is usually very strictly limited to losses caused directly by fire or lightning. It is possible, however, to purchase "extended coverage options" on fire insurance policies which will give protection against smoke damage, explosions, windstorms and even relatively unlikely events, such as riots and cars or airplanes crashing into your building.

Fidelity Bonds

An entirely different variety of insurance, usually called fidelity bonds, is available to protect against financial wrongdoing by the day care program's employees. Fidelity bonds protect the program from any financial loss as a result of embezzlement by a staff member with access to the program's funds or from ordinary stealing.

There are three different types of fidelity bonds. Individual bonds protect the program only against the wrongdoing of one specific named individual. Schedule bonds protect the program against wrongdoing by any employee whose name or position is on a list (the "schedule") presented to the bonding company. Blanket bonds protect the program against loss by embezzlement or similar action by any employee of the program.

A program considering bonding named employees should be aware that the bonding company will conduct a character investigation regarding the employees before it determines whether to issue the bond.

Health Insurance

As a day care program becomes somewhat stable financially, it may wish to consider offering an employee group health insurance plan as a fringe benefit. Although there are many variations, group health insurance plans come in three major types. The first type is composed of those whose benefits cover only basic medical and hospitalization costs plus the costs of medication. The second is the so-called "major medical plan" which attempts to cover the costs of what are called "catastrophic" illnesses. Increasingly, these first two are combined in a single policy. The third is composed of the disability income plan which is a policy that pays an employee a certain percentage of his or her regular salary if the employee should suffer a long-term physical disability. People considering obtaining major medical plan coverage should be aware that insurance companies frequently require participants in major medical plans to purchase a small life insurance policy as well.

CONTRACTS

Insurance policies are by no means the ~~only~~ kind of contracts the typical day care program will enter into. In addition there are employment contracts, leases, contracts with parents for fees, contracts for food and supplies, contracts for personal services (of accountants, plumbers, maintenance people, etc.), contracts with funding sources, and various others. It is important that the operator(s) of a day care program have some familiarity with the nature of contracts in order to be able to run the program responsibly.

The essence of a contract is that it is a legally enforceable agreement. It is, in a sense, a promise which can be legally enforced. Unlike most promises, which at most have a certain "moral" obligation attached to them, a contract represents a promise which you have a legal obligation to fulfill. And, as with all legal obligations, if you do not fulfill it, you subject yourself to potential penalties.

There are three central elements of a contract, all three of which must be present in order for an agreement to be classified as a contract and therefore as a legally enforceable promise. The three central elements are:

- the offer;
- the acceptance;
- the consideration.

The offer is, sensibly enough, simply your proposal to the seller to buy a certain object at a certain price, or the seller's invitation to you to buy the object at that price. The acceptance is the seller's indication that he will supply the object you propose to buy at the quoted price, or your indication that you accept the seller's invitation to purchase it at that price. Consideration is simply the fancy legal word for the price or value of what each party exchanges. Thus, for example, if you have a catalog from a stationery store which indicates that crayons are for sale at 79¢ per box and you send the store your purchase order for 100 boxes, after which they are delivered to your program, your purchase order (or it could be your letter or telephone call) is the offer; the delivery of the crayons indicates the acceptance; and the consideration on your part is $79, while the consideration on the store's part is the 100 boxes of crayons.

Often people enter into contracts without knowing they have done so. Three misconceptions account for this situation. The first misconception is that a contract has been entered into only when a written document has been signed. This is not true; oral contracts are legally enforceable.

The second misconception is that contracts are entered into only when some particular formalities are observed, such as exchanging confirming letters or something. This is not true; no particular formalities are required provided the three elements noted above are present.

The third misconception is that a contract exists only where an exchange of money is involved. This is not true; the consideration in a contract need not involve an exchange of money. The consideration requirement for a binding contract merely requires that something of value be exchanged. Thus, if you agree with John Jones to admit his three children to your program for a year in exchange for his cleaning the building every weekend, you have entered into a contract where Jones' consideration is his cleaning services and your consideration is your day care services provided to his children.

As indicated above, if you do not fulfill your obligation under a contract or, in other words, if you fail to provide your consideration, you subject yourself to potential penalties. The failure to fulfill your obligation, or "breaking" the contract, is called a "breach" and the potential penalty is referred to as the "damages" for the breach. The damages you incur for a breached contract are the sums you must pay to the other party to the contract. Thus the principal consequence of a contract breach is that it renders you liable to the other party for the financial impact your act has on that party. To take a simple example, if you entered into a contract to hire a plumber to do some work in your center and after the plumber arrives you decide for some reason that you don't want the work done after all, the plumber would have the right to seek damages from you in the amount of profit he expected to earn from the job. (There are some additional relevant legal refinements, but the example illustrates the main principle at work.)

Of course, in every contract breach situation, such as this one, there is what is called the problem of proof. The proof problem is a reference to the difficulty one has in literally "proving" by legally sufficient evidence that a valid contract was entered into and was breached. Obviously, this is a substantial difficulty where oral contracts and other contracts of a relatively informal nature are involved.

Recognition of this proof problem leads many people to treat contract breaches rather casually on the theory of "don't worry about it, they'll never be able to prove it" or a variant theory of "even if they could prove it, they won't go to the bother". While this attitude is frequently fairly descriptive of reality, it is not one which is recommended to a day care program operator who is interested in running the program in a way which is responsible and which avoids potential liabilities as much as possible. In addition, as many programs have painfully discovered, even a claim which ultimately will be unsuccessful because of proof problems or other reasons, can be a prolonged and time-consuming hassle if treated too casually at the outset.

LIABILITY AND BOARD/DIRECTOR/STAFF LEGAL RELATIONSHIPS

How to Think About it

The Types of Legal Relationships

The Types of Legal Responsibility

Three Central Principles

Variations in Liability Depending on Organizational Form

Putting It All Together

Chapter VI

LIABILITY AND BOARD/DIRECTOR/STAFF LEGAL RELATIONSHIPS

HOW TO THINK ABOUT IT

This chapter will consider issues of liability resulting from accidents or from other types of torts or from breaches of contract and will consider these issues in terms of the legal relationships between the staff, the Executive Director and the Board of Directors. Consider the following two situations:

1. Jane Jones, the Executive Director of the Happy Times Day Care Center, which is a not-for-profit corporation, was authorized last year by the Board of Directors to hire part-time employees at her own discretion whenever she considered it necessary so long as she reported her actions at the regular Board meetings. She hired Mary Murphy to come in for two hours each day to prepare a hot lunch for the children. One of the children wandered into the kitchen while Mary was working. Mary didn't see the child and accidently spilled boiling water on him. The child was badly burned, required extensive medical treatment for weeks, and his parents are planning to file a legal action. The Center doesn't have liability insurance, although Jane and the Board "have been thinking about it for a while". Who is liable for the expenses of the child's injuries--Jane, the Executive Director, or Mary, the cook, or the Board of Directors, or some combination of them?

2. The same situation described above except that this time the child was injured accidentally by Lena Lewis, who is an accountant Jane has hired to be a consultant to the program periodically. Lena, who comes into the Center several hours a month whenever Jane and her bookkeeper need a little extra assistance, had gone into the kitchen to make herself a cup of coffee when she accidentally spilled water on a child she didn't see behind her. Who is liable this time--Lena, or Jane, or the Board, or some combination of them?

Wondering about the answers to questions such as these has given many a day care operator a nervous headache.

Indeed, for many people involved in day care services the most worrisome organizational issue involves the various forms of legal (and, ultimately, financial) liability they are subject to if something goes wrong in the program. And in a program which is incorporated, probably the most confusing aspect of this liability issue is trying to figure out who is legally responsible for what in an organization which includes a staff, an Executive Director (or similarly titled person), and a Board of Directors (or Trustees or Overseers).

This liability issue involves a substantial number of legal complexities and it is beyond the scope of this Handbook to explore them in detail. In addition, since there is an endless number of possible details in a liability-producing situation and since differences in detail often produce differences in legal result, this is an area where it is often useful to seek some professional advice rather than relying entirely on your own judgment.

Nevertheless, the law concerning liability and the legal relationships between staff members, their Director and the Board of Directors is not so mysterious and complex as to be understandable only by an attorney. It is possible for a person without legal training to quickly grasp the basic principles involved and to develop a method for thinking about problems involving liability and responsibility, a method which will in most instances enable you to give quite accurate answers to your own questions. The purpose of this portion of the Handbook is to describe these principles and that method.

The method for thinking through issues of liability and legal relationships involves asking yourself four questions and evaluating the answers to those questions in terms of the information summarized in this chapter. The four questions are:

- What type of <u>legal relationship</u> do the people who are potentially liable have with regard to each other?
- What type of <u>legal liability</u> is involved in the act in question?
- How do the <u>three central principles</u> described in this chapter apply to the situation?
- What is the legal <u>form of organization</u> of the day care program?

THE TYPES OF LEGAL RELATIONSHIPS

In any day care program which employs more than a very small number of people, there are likely to be people in positions or roles which, in terms of legal categories, constitute three different types of legal relationships. The <u>three types</u> of legal relationships are:

- Principal and Agent;
- Employer and Independent Contractor;
- Master and Servant.

Offensive though they are, the terms <u>master and servant</u> which have been used for hundreds of years in the law to describe what we now call employer and employee are still used frequently in the law to describe the employer-employee relationship. Legally, a "servant" (employee) is a person who is employed by another person on a regular basis to perform a general range of duties and who is subject to the orders of that other person (or the other person's representative) with regard to the specifics of how the general duties shall be carried out. Most people who work in a day care program will be in this category.

The employer/independent contractor relationship is quite different from the master and servant relationship. Examples of independent contractors would include psychologists, plumbers, accountants, auditors, lawyers, curriculum consultants, etc. Unlike the situation with an employee, the employer has no right to give orders regarding the details of the independent contractor's work. Also unlike the employee, the independent contractor is generally hired for a very specific purpose and for a very limited time. And, usually, the employer is not as skillful as the independent contractor at whatever the independent contractor has been hired to do.

The principal/agent relationship is one which exists with reference to contracts. The principal is the person for whom a contract is made and who will be liable for any breach of it. The agent is the person who actually makes the contract (signs it, places the order, etc.). Thus an agent is a person who has the power to make contracts between the principal and third parties (stores, suppliers, insurance companies, etc.) which are legally binding on the principal. This power is called "agency". Although there are some exceptions, the general rule is that the power of agency is acquired only in situations where the principal specifically grants it or knowingly permits someone to act as though he or she has it. Thus, employees and independent contractors do not normally have agency power. Typically, the Board of Directors (the principal in an incorporated program) will specify that the Executive Director is its agent in contract matters.

THE TYPES OF LEGAL RESPONSIBILITY

There are two major types of legal responsibility: criminal and civil. We won't concern ourselves with crime here since it is a much less likely event in a day care program, but it should be noted that certain crimes, particularly embezzlement, tax fraud and assault do occur in day care settings. Civil responsibility is divided into two categories:

- Contract liability;
- Tort liability.

Contract liability, as indicated earlier, is simply your responsibility for the financial consequences of breaching (violating or breaking) a contract.

Tort liability is a bit more complicated. As explained in Chapter I, a tort is something which is illegal but which isn't a crime and isn't a contract breach. It is sometimes referred to as a "civil wrong". There are two pairs of sub-categories of torts:

- Physical and non-physical torts;
- Intentional and negligent torts.

Examples of physical torts include trespass, false imprisonment, and conversion, which is similar to stealing. Examples of non-physical torts include libel, slander, and misrepresentation. Trespass is the best example of an intentional tort. A negligent tort is an act which an ordinarily prudent person would not do, such as leaving a banana peel on the kitchen floor.

The vast majority of torts are a result of negligence and courts frequently find negligence in situations where the average person, thinking only of the common usage of the word "negligence", would not think negligence had been involved. In the two situations described at the beginning of the chapter, it is probable that both the cook and the accountant would be considered negligent. It is possible, also, that the Board of Directors would be considered negligent for permitting the center to be operated in such a fashion that children could enter the kitchen unnoticed.

THREE CENTRAL PRINCIPLES

In thinking through issues of liability and legal relationships to determine who is ultimately responsible for the financial consequences of an accident or of something else which "goes wrong" in the program, there are three central legal principles which must be understood.

- Scope of authority;
- Doctrine of respondeat superior;
- Liability differences determined by employment relationships.

The principle of <u>scope of authority</u> is based on the notion that ordinarily an employee is hired to perform a general range of duties of a certain type and that there are customary expectations about what those duties involve and how they will be performed. When an employee's actions are consistent with those expectations, the employee is said to be "acting within the scope of authority" of the job. Long ago the law developed a rule that when an employee is acting within the scope of authority of his or her job, the employee is not personally liable for the financial consequences of his or her actions; and when an employee's actions are outside the scope of authority, he or she will be held personally liable.

As an illustration, if Mary is hired as a cook and she spills hot food on someone while serving, she generally would not be held personally liable because serving hot food is within her scope of authority. But if John is hired just to shovel snow off the sidewalk and driveway and he, for some reason, ends up serving hot food which he spills, he may very well end up being personally liable since serving food is not within the scope of authority of what he was hired to do.

The phrase "respondeat superior" is just a lawyer's way of expressing in Latin the idea that "my boss is responsible" for anything I do wrong". Under the doctrine of respondeat superior, whenever an employee is engaged in the business of the organization and is acting within the scope of authority of his job, it is the employer who is responsible for the financial consequences of the employee's acts and not the employee himself. Thus in the first situation described at the beginning of the chapter, the respondeat superior doctrine would protect the cook against personal liability and would make her employer, the program (through its Board of Directors), liable. The respondeat superior doctrine applies only to employees and not to independent contractors. So, in the second situation described at the beginning of the chapter, the accountant, who is an independent contractor rather than an employee, would be personally liable.

It should be apparent now that whether liability is imposed on a person or not, often depends on the category of employment relationship (employer, employee, independent contractor, principal, agent) which applies to the person. Three simple rules can summarize the differences in liability depending on category of employment relationship:

(1) Employers are not responsible for torts committed by independent contractors; the independent contractor is personally responsible.

(2) Employers are responsible for torts committed by employees; the employees are not personally liable, so long as they were engaged in the business of the organization and were acting within the scope of their authority.

(3) Principals are not responsible for the physical torts, such as trespass, committed by their agents; but they are responsible for

non-physical torts, such as libel or slander, committed by their agents.

VARIATIONS IN LIABILITY DEPENDING ON ORGANIZATIONAL FORM

As indicated above, the issue of who is liable is largely determined by employment relationships within the organization; the issue of how much liability there will be is largely determined by the legal form of organization the day care program has chosen for itself. For day care programs which are run as sole proprietorships or as partnerships or as profit corporations, the program is fully liable for all claims. This means that once liability has been determined, the program is obligated to pay the full amount of the liability no matter how high it may be.

For day care programs which are operated as not-for-profit corporations, their liability is limited in many states by the charitable immunity doctrine, an ancient legal rule that strictly limited the extent of liability of such organizations. The extent to which this doctrine is in force and the degree of limitation on liability where it is in force vary considerably. To find out whether it applies in your state, you can inquire at the same state office where incorporation papers for not-for-profit organizations are filed.

For day care programs which are operated by public agencies, the amount of liability is limited in most states by the doctrine of sovereign immunity (sometimes called "governmental immunity"). Under this doctrine, which is very similar to charitable immunity, public agencies can be held liable for the financial consequences of acts like torts only to a very limited extent. The extent of their liability is established either in a state statute or by a decision of the state courts.

PUTTING IT ALL TOGETHER

In thinking about situations which may involve financial liability, the first thing to consider should be whether you have acquired all the types of insurance you need and, if you have, whether you have acquired coverage in amounts which are adequate in terms of the potential risks. Any program which has no insurance or only token amounts of insurance is taking a serious gamble which could have very unfortunate consequences.

A review of the information presented in this Chapter and in Chapter V should enable you to reach a conclusion about your program's insurance status and to think through liability situations to a conclusion about who will be held responsible. It should be pointed out, however, that there is always the possibility that ~~your insurance~~ company may discover some reason why your policy doesn't cover some particular event or the possibility that you may have misjudged what is an adequate amount of insurance.

The information presented in the Chapter can be summarized in the following manner: the first question to ask yourself is what type of liability is involved? Is it criminal or civil and, if it's civil, is it a breach of contract or a tort? Then ask what type of legal relationship exists between the people whom you think are potential candidates for liability--are they employer and employee or employer and independent contractor or principal and agent? Next, consider how the three central principles apply to the type of responsibility and type of legal relationship you concluded were involved.

For instance, if the situation involves a tort committed by an employee, was the employee acting within the scope of his or her authority at the time of the accident? If the answer is yes, the principle of respondeat superior will make the employer and not the employee liable. Or, if the situation involves any kind of tort committed by an independent contractor or a physical tort committed by an agent, then that person will be liable personally.

Finally, if you have concluded it is the program (as employer or principal) which will be liable, consider whether the organizational form (corporation, partnership, etc.) of your day care program has any effect on the amount of liability. If the program is run as a sole proprietorship or a partnership or a profit corporation, it will be fully liable. If it is a not-for-profit corporation or a public agency, there may well be some limit on the amount of liability set by state law under the two immunity doctrines mentioned above, but it's unwise to rely too heavily on this.

As an illustration of this reasoning process at work, consider the following:

1. Theresa Trubble was hired as a "teacher's aide" at Happy Times Day Care Center, a not-for-profit corporation of which Jane Jones is the Executive Director. The Center is in a state which has abolished the charitable immunity doctrine and therefore doesn't limit liability of not-for-profit corporations. Theresa was recently fired and Jane has now received an employment questionnaire from a place where Theresa has applied for work. On the questionnaire Jane writes that "Theresa was uncooperative, habitually late, often arrived in an intoxicated condition, and doesn't seem competent to care for small children." Theresa doesn't get the job, is shown the questionnaire, and sues Happy Times Day Care Center.

As Executive Director, Jane is the agent of the Board in all contract matters, including terminating employment contracts. Jane's statement on the questionnaire may well be libel, which is a non-physical tort. A principal (the Board) must bear the liability for a non-physical tort performed by an agent. Therefore, if Theresa wins her suit, the program, not Jane, will be liable and it will be liable for whatever amount Theresa is awarded since there is no limitation on liability in that state.

2. Prior to being fired, Theresa Trubble participated in the monthly "staff days" at which problems with the kids, problems between staff members, new instructional materials, etc. were always discussed. Jane had hired a psychologist to sit in on these meetings to act as a facilitator, a non-involved observer, and a professional resource person. This was the psychologist's only involvement at the Center. In the course of the last meeting before Theresa was fired, the psychologist said to the entire staff the same sentence which Jane wrote on the employment questionnaire above. Theresa has filed suit against the Center for the psychologist's statement also.

The psychologist's statement may well be slander (slander is oral; libel is written). Slander is a non-physical tort. However, the psychologist is an independent contractor and not an employee or an agent. Employers are not responsible for the torts of independent contractors. Consequently, the Center will not be liable for the psychologist's statement, but the psychologist would be liable personally if Theresa filed suit against him or her and won.

3. One of Theresa's duties as a teacher's aide was to keep the records of the children up-to-date with medical reports, permission slips, instructions from home, entries about special difficulties, etc. A social worker from a state agency which had as a client the mother of one of the children at the Center called and asked a number of questions about the child. Theresa read the contents of the child's file to the social worker. The child's mother has filed suit against the Center for invasion of privacy.

Invasion of privacy is a tort. Theresa was an employee of the Center at the time. Unless there is something in the personnel policy or in Theresa's job description prohibiting giving out information, Theresa's act was probably within the scope of her authority--it was reasonably related to what she was hired to do. Consequently, if the parent wins, the Center will be liable as the employer of an employee who committed a tort while acting within the scope of authority of her job; Theresa would not be liable personally.

Despite all the dire possibilities explored in this Chapter and elsewhere in the Handbook, being a day care provider need not be thought of as a hazardous occupation. The key to avoiding difficulties is to have an awareness of how they might arise. Armed with that awareness, day care providers can protect themselves against most problems simply by thinking through the implications of their plans and by taking a few prudent actions in advance. The goal of this Handbook has been to develop that awareness and to outline some of those actions.

Postscript

The Educational Resources Information Center/Early Childhood Education Clearinghouse (ERIC/ECE) is one of a system of 16 clearinghouses sponsored by the National Institute of Education to provide information about current research and developments in the field of education. The clearinghouses, each focusing on a specific area of education (such as early childhood, teacher education, languages and linguistics), are located at universities and institutions throughout the United States.

Each clearinghouse staff searches systematically to acquire current, significant documents relevant to education. These research studies, speeches, conference proceedings, curriculum guides, and other publications are abstracted, indexed and published in Resources in Education (RIE), a monthly journal. RIE is available at libraries, or may be ordered from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

Another ERIC publication is Current Index to Journals in Education (CIJE), a monthly guide to periodical literature which cites articles in more than 700 journals and magazines in the field of education. Articles are indexed by subject, author, and journal contents. CIJE is available at libraries, or by subscription from Macmillan Information, 909 Third Avenue, New York, N.Y. 10022.

The Early Childhood Education Clearinghouse (ERIC/ECE) distributes a quarterly newsletter which reports on new programs and publications and RIE documents of special interest. For a complete list of ERIC/ECE publications, or if you would like to subscribe to the Newsletter, write: ERIC Clearinghouse/Early Childhood Education, University of Illinois, 805 West Pennsylvania Avenue, Urbana, Illinois 61801.

THE ERIC CLEARINGHOUSES

CAREER EDUCATION
Center for Vocational Education
Ohio State University
1960 Kenny Road
Columbus, Ohio 43210
(614) 486-3655

COUNSELING AND PERSONNEL SERVICES
The University of Michigan
School of Education Building
Room 2108, East Univ. & South Univ.
Ann Arbor, Michigan 48109
(313) 764-9492

*EARLY CHILDHOOD EDUCATION
University of Illinois
805 West Pennsylvania Avenue
Urbana, Illinois 61801
(217) 333-1386

EDUCATIONAL MANAGEMENT
University of Oregon
Eugene, Oregon 97403
(503) 686-5043

HANDICAPPED AND GIFTED CHILDREN
The Council for Exceptional Children
1920 Association Drive
Reston, Virginia 22091
(703) 620-3660

HIGHER EDUCATION
George Washington University
1 Dupont Circle, Suite 630
Washington, D.C. 20036
(202) 296-2597

INFORMATION RESOURCES
School of Education
Syracuse University
Syracuse, New York 13210
(315) 423-3640

JUNIOR COLLEGES
University of California
96 Powell Library Building
Los Angeles, California 90024
(213) 825-3931

LANGUAGES AND LINGUISTICS
Center for Applied Linguistics
1611 North Kent Street
Arlington, Virginia 22209
(703) 528-4312

READING AND COMMUNICATION SKILLS
1111 Kenyon Road
Urbana, Illinois 61801
(217) 328-3870

RURAL EDUCATION AND SMALL SCHOOLS
New Mexico State University, Box 3AP
Las Cruces, New Mexico 88003
(505) 646-2623

SCIENCE, MATHEMATICS, AND ENVIRONMENTAL EDUCATION
Ohio State University
1200 Chambers Road, Third Floor
Columbus, Ohio 43212
(614) 422-6717

SOCIAL STUDIES/SOCIAL SCIENCE EDUCATION
855 Broadway
Boulder, Colorado 80302
(303) 492-8434

TEACHER EDUCATION
1 Dupont Circle N.W., Suite 616
Washington, D.C. 20036
(202) 293-7280

TESTS, MEASUREMENT AND EVALUATION
Educational Testing Service
Princeton, New Jersey 08540
(609) 921-9000, Ext. 2176

URBAN EDUCATION
Teachers College, Box 40
Columbia University
New York, New York 10027
(212) 678-3438

*ERIC/ECE is responsible for research documents on the social, psychological, physical, educational, and cultural development of children from the prenatal period through pre-adolescence (age 12). Theoretical and practical issues related to staff development, administration, curriculum, and parent/community factors affecting programs for children of this age group are also within the scope of the clearinghouse.