

REPORT TO THE BOARD OF DIRECTORS OF THE DENVER ART SOCIETY, A COLORADO NOT-FOR-PROFIT CORPORATION, REGARDING THE RESULTS OF LEGAL COUNSEL'S INVESTIGATION OF THE BUSINESS STRUCTURES AND ACTIVITIES OF THAT CORPORATION AND THE DENVER ART SOCIETY COOPERATIVE

Submitted by,

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January 8, 2017

INTRODUCTION

I have agreed to act as *pro bono* legal counsel to the Board of Directors of The Denver Art Society, a Colorado Not-For-Profit Corporation (hereinafter referred to as "DAS") to investigate, evaluate and advise the Board and the members of DAS regarding perceived issues with the structure and operations of both DAS and the Denver Art Society Cooperative. In that capacity, I was authorized by the Board of Directors of DAS to review all of the documents and records of both organizations for the purposes of determining the legal structure and status of both organizations and to identify any important issues that might arise in the course of my investigation. This authorization was also provided by vote of the membership of The Denver Art Society Cooperative (hereinafter referred to as "the COOP").

I have reviewed the Articles of Incorporation, Bylaws, Liability Waiver, Membership Agreement, Board Member Agreement, financial reports, 501(c)3 documentation, business formation and organizational documents, mission statement(s) and business plan(s) of DAS. There are no such separate documents attributable to the COOP, as the COOP currently operates as a "project" or "program" of DAS under complete DAS ownership and control. This fact was established through review of a PowerPoint document called the "DAS Cooperative Structure" located in the DAS files, as well as through the DAS's financial reports.

In summary, DAS was formed on August 14, 2009 as a Colorado not-for-profit corporation. That corporation was granted 501(c)3 status by the IRS as an educational charity. Specifically, the only activity identified by DAS on the 501(c)3 application as an activity the DAS would engage in was the operation of a school. The DAS' Mission Statement, as contained in its Bylaws, states:

"We believe universal access to the arts is essential to sustaining a healthy society. Our project, Denver Public Art University, is organizing the La Alma neighborhood to provide all students with access to free and complete education in the arts, public exhibit spaces, and active community engagement."

According to the draft “DAS Cooperative Structure” and as verified through DAS’ financial reports, the COOP was started and continues to run as a program operating under the DAS. Unlike DAS’ other programs (Denver Public Art University and DPAU West), DAS never applied for or obtained a registered trade name for the COOP. (This may actually be a good thing, as it means that the name “Denver Art Society Cooperative” is still available should DAS, the COOP or its members wish to secure it.) Legally, all COOP activities are deemed to be activities of DAS. The COOP’s main operations involve the management of the gallery and the processing of the sales of the work of individual artist members on behalf of those members, with the proceeds of those sales being distributed to the artist members whose art is sold. The COOP also hosts events, provides some art classes and workshops and attempts to participate in a positive way in the community of the surrounding neighborhood. The mission statement of the COOP, as it is stated on our website is as follows:

“The mission of Denver Art Society Cooperative is to collectively host a creative community where people of all ages can view, learn, and exhibit local art in all forms.”

The DAS Articles of Incorporation show that DAS has no voting members. According to the DAS Bylaws, DAS is run exclusively by its Directors. The Bylaws require a minimum of 7 directors; and vacancies on the Board may be filled by the acting Directors according to “community voting.” It is left up the Board to determine what that means and who or what constitutes the “community.” Since DAS has no voting members, the Board must decide who has the right to vote for Directors and the manner in which voting will take place and be counted.

My review has brought several important issues to light, some of which, unless corrected forthwith, could result in significant legal problems for DAS and its members; and could result in the DAS and the COOP both having to cease all operations. Below, I will describe these exigent and problematic issues in turn; and then I will offer my recommendations on what I believe to be the best way to resolve each and all of them so as to allow both organizations to continue with their respective missions and activities.

THE PROBLEMS

Membership and Voting Rights

Since the COOP is not a separate organization, anyone who is currently a member is technically a member only of DAS. However, DAS does not have voting members; and the Bylaws make no provision whatsoever for the operation of the COOP. In short, while we may feel we are accomplishing great things by voting at our meetings, we have no authority to impose the results of our votes on anyone, even ourselves. Our votes are technically meaningless, except to the extent the Board of Directors may choose to abide by them. Also, since there are no separate COOP bylaws, all of the principles by which the COOP is ostensibly organized and operated are NOWHERE TO

BE FOUND and NOT BINDING upon any of the “members” or upon DAS. Legally, these principles might as well not even exist other than as voluntary ideals relative to the COOP and its members as a whole.

The DAS Board of Directors

The Bylaws of DAS state that there shall be a minimum of 7 directors. We are currently 4 directors short of this quota. Also, the process for replacing vacancies is flawed in that there does not seem to be a clear procedure for filling vacancies on the Board. Specifically, the Bylaws provide that directors are supposed to be appointed by existing directors from one or more candidates elected by “community vote.” Of course, the Bylaws do not specify what community we are talking about or what the voting procedures are. This is left up the Board to set these policies by resolution. As we have seen, this structure can be and has been problematic in the past, especially when the Board’s action is required, for example to purchase insurance or to negotiate and/or sign a new lease.

DAS’ Status as a Not-For-Profit Corporation and as a 501(c)3 Tax Exempt Organization

As stated earlier, DAS currently operates the COOP as a program of DAS. This means that the COOP’s activities, just like DAS’, must qualify as not-for-profit operations conducted in accordance with DAS’ stated charitable purpose. Unfortunately, we fail on both counts.

The COOP is not a not-for-profit activity because proceeds from the sales of art through the COOP are distributed to member artists. This makes it an operation for profit. To be not-for-profit, all of the proceeds from all art sales would have to go to DAS for its exclusive use in furtherance of DAS’ charitable purpose of running a school and could never be distributed to any individual artist.

The COOP is not currently conducting the majority of its activities according to DAS’ charitable purpose of running a school. Its activities are almost exclusively dedicated to the creation, display and sale of the art of individual members. Even the COOP mission statement clearly defines completely different activities than does the mission statement for DAS.

What this means, simply put, is that DAS is currently in violation of its status as a not-for-profit in Colorado; and of its status as a 501(c)3 tax exempt organization under the Internal Revenue Code (“IRC”). As a result, both the DAS and the COOP are in real danger of being legally hammered, even if only for all of the back federal and state taxes DAS would owe. Both the DAS and the COOP could quite conceivably go out of existence altogether.

Finally, DAS’ current COOP activities, being carried out informally, could be in violation of federal anti-trust statutes; and DAS’ sales of memberships could be problematic under both federal and state securities laws.

PROPOSED SOLUTIONS

The issues regarding DAS' member voting rights and Board of Directors' issues are fairly simple to resolve. DAS can file amended Articles of Incorporation, establishing that DAS' members have voting rights. The DAS Board can adopt a resolution that clarifies who has the right to elect new Board members and how, select the Executive Director, and determine other issues connected to the existence and operations of DAS.

As far as the DAS Board issues are concerned, the Board only needs to authorize and adopt an amendment to the DAS's Bylaws defining members' rights and obligations, including voting rights, requirements for membership, etc. Once this has been done, the members can vote on candidates to fill the (currently) 4 vacant DAS Board positions. The Board of Directors will continue to run DAS but can be removed and replaced by vote of the Members if there is good reason.

The problems with DAS' Not-For-Profit and 501(c)3 statuses resulting from DAS running and financing the COOP, and the problems with potential member liability and DAS' potential liability under state and federal anti-trust or securities laws are much more serious and the solution is much more complex. However, I believe there is a solution which will work with the solutions outlined above for the issues related to membership, voting and the Board of Directors. In a nutshell, here it is:

1. First and foremost, the COOP needs to organize as a separate legal entity immediately, if not sooner. There are potentially several business forms the COOP could consider, such as a partnership, LLC, limited partnership, corporation, S corporation, etc. However most of these business formations have serious downsides. General Partnerships, and sole proprietorships are business forms that would not shield members from personal liability. As a result, each and every current member of the COOP participating in COOP business could subject each and all of the other current members to personal liability for whatever happens in the COOP. This would not be covered by DAS' current liability insurance. LLCs, Limited Partnerships, corporations and S corporations all provide liability protection to the members/partners/shareholders but may still run afoul of anti-trust or securities laws unless their controlling documents are very carefully drafted. General Business Corporations (so-called "C Corporations") provide liability protection, but still would be subject to anti-trust and securities laws AND their income is subject to double-taxation. Only a special type of corporation, called a "Cooperative Association" would provide not only liability protection, but also statutory immunity from any anti-trust or securities laws and the ability to have greater flexibility in setting its operating policies than a regular business corporation AND would allow the COOP to enjoy favorable income tax treatment as a Cooperative.

For purposes of favorable income tax treatment, greater flexibility in defining COOP operations, and to eliminate problems with member liability or issues with anti-trust or securities laws, I recommend that the COOP reorganize in the form of a Cooperative Association, incorporated under Title 7, Article 56 of the Colorado Revised Statutes (“CRS”).

2. At this point, DAS would cease all operations connected with COOP activities and the new Denver Art Society Cooperative would take over. Unfortunately, DAS cannot help with any start-up capital. Any assets that DAS obtained through the efforts and activities of the old COOP would remain with DAS. However, the new COOP will have other options for ways to generate capital.
3. The COOP will be owned by its members, who will each have one vote, just the way a COOP is supposed to be. Colorado law requires that a Cooperative Association incorporated under Title 7, Article 56 CRS has to have a Board of Directors consisting of at least 3 members and a Chairman of the Board of Directors. The Cooperative Association may also elect a Secretary, Treasurer and any other officers the Cooperative Association might choose to elect. To simplify matters and to ensure that all Members have authority to vote on *everything* connected to the existence and operations of the COOP, the Board will be a “collective board,” which in plain English means that every member will also be on the Board of Directors. The membership will also be able to clearly define and limit the duties and authority of the Chair, Secretary, Treasurer, etc. as well as that of Steering Committee.
4. Membership in the COOP should require membership in DAS as a prerequisite. This way, new members will actually become members of both DAS and the COOP. Dual membership would be automatic but separate member agreements, liability waivers, etc. will need to be signed for both DAS and the COOP. Also, the vast majority of membership dues can thus continue to be paid to DAS since DAS depends upon those funds to pay the lease on the gallery space. \$1 or some other small amount of each membership payment would go to the new COOP and the rest would go to DAS. (We can continue collecting membership dues through the website by running those payments through a special trust that will receive, divide and distribute the dues between DAS and the new COOP while keeping the dues payable to DAS separate from those payable to the new COOP.) If either DAS’ or the COOP’s members determine that DAS or COOP membership dues should be raised to cover DAS or COOP operating costs, either DAS or the COOP can do so with any such dues increase being directed to the appropriate organization. All membership dues going to the COOP would be treated as capital investments by the members paying dues. As such, membership dues would not be taxable to the COOP and would mean that

the dues-paying members would truly *own* the COOP, much in the same way that shareholders own a regular business corporation.

5. This dual membership scenario allows the COOP to continue conducting business pretty much as usual by simply defining and reassigning the respective roles and obligations of DAS and the COOP. There will need to be a "Use & Occupancy Agreement" between DAS and the COOP setting out in detail the terms of the relationship between DAS and the COOP and the terms under which the COOP will occupy and manage the gallery space, while still allowing DAS to cover rent, capital improvements and other costs related to the gallery space through membership dues and alternate sources of funds only available to 501(c)3 organizations, such as grants and tax-free fundraising activities, all without jeopardizing its Not-For-Profit or 501(C)3 statuses.
6. Member/Directors will then need to appoint a Chair, a Secretary and a Treasurer (and I would advise election of a vice-chair as well so that there is someone to carry out the chair's duties if the chair is unable to act for some reason). The chair and other officers, as well as any other officers we may decide to have, would essentially make up what is now the "Steering Committee." The Steering Committee would act as advisors to the Board and to the members, with the members/directors having the ultimate authority to direct the operations of the COOP through voting in their dual capacities as members and directors. Functionally, the Steering Committee would really remain what it is currently but its existence will be "official" and its powers well-defined.
7. Since the COOP will now be a separate legal entity, the COOP will be unconnected to DAS in any way legally other than by contractual relationship (which will mainly consist of the Use & Occupancy Agreement). As a result, the new COOP will need to adopt its own Bylaws and other business formation documents; and the COOP will need to put some formal procedures in place so that the COOP can qualify for favorable treatment as a Cooperative Association under Colorado law and for favorable tax treatment under Subchapter T of the Internal Revenue Code. This will unfortunately require more structure in the areas of record-keeping, proper organization and conduct of member/board meetings and so forth. This means that we will have to establish some procedures that will have to be followed, even when we are not "in the mood." However, these formalities can be easily manageable if we stay on top of them and would arguably be well worth it for the benefits they would provide.
8. Without getting too technical here, the COOP will not enjoy tax exempt status under Internal Revenue Code ("IRC") §501(c)3. This is simply not possible. The COOP is a for-profit operation and we need to embrace that rather than try to sneak around it. The COOP can take advantage of some favorable tax treatment

as a Cooperative Association under Subchapter T of the IRC, which would allow the Cooperative to operate with very little, if any, tax liabilities *if we structure the COOP and run it according to some very important formalities*. This will require special provisions in both the Bylaws and the Member Agreements. It will also require some additional documents, such as per-unit retain certificates, membership certificates, and so forth. I can prepare all of these documents for the COOP and would be happy to do so.

9. Because there must be a complete separation of DAS from the COOP, some of our systems will have to become redundant. For example, we will need at least 2 new bank accounts for the COOP (one general account and one fiduciary account for funds the COOP might receive on behalf of DAS as charitable contributions), a separate EIN number, a separate Google Drive account, and a separate QuickBooks account. Accounting for COOP activities and storage and management of documents will have to be completely separate from DAS' accounting and record-keeping systems. Other systems, such as Square, can simply change hands. We will also have to figure out how to deal with the website content and make any content changes needed to ensure that the website content is not misleading in any way. None of this should pose a major problem at all.
10. Because we will be forming the COOP under Title 7, Article 56, CRS, we will have a great deal of latitude to determine how the COOP will be run through the Bylaws. This where we can define voting rights and procedures. We can also define membership requirements, rights and obligations, and management. We can also define how we vote (e.g., consensus voting, modified consensus voting, majority voting, etc.), as well as the other important parts of what will be the operating framework of the COOP.

We will also be able to define the processes and procedures for processing of sales, treatment of receipts and the treatment of both patron refunds and per-unit retains in such a way as to minimize tax exposure for the COOP (or the members). At the same time, we will still be able to pay members their sales proceeds (less the current 20% for administrative costs, Square fees and sales taxes.). However, members will now also be eligible for refunds of at least a portion of their 20% cut to the COOP after the end of each fiscal year in the form of per-unit retain payments and/or patron refunds from net COOP earnings. This is something that the members do not have now.

The trade-off will be that all sales through the COOP, even cash sales, will have to be processed through the COOP and will have to be subject to the 20% cut to the COOP. This will be true, whether the artist whose work is sold has his or her own sales tax license or not. (Remember that the members would still be eligible

for refunds of at least a portion of their 20% cut to the COOP after the end of each fiscal year.) All sales taxes, whether the payment is received in cash, check or credit card, will have to be paid by the COOP, all fee for credit card sales will have to be paid by the COOP, and the COOP will have to keep track of the sales and distribute the members' 80% to the members. Of course, a member with his or her own sales tax license (and their own credit card processing service provider for credit card sales) may process any of his or her own sales individually rather than through the COOP, but this will require that the member actually be present in person to process such a sale. In such transactions, all proceeds of the sale would go directly to the member with no 20% cut to the COOP since the transaction did not go through the COOP and the COOP did not receive possession of the payment.

11. Since the COOP will not be able to engage in "charitable fund raising" activities, the way we treat sales and any funds going to the COOP from sales will be very important in providing funds for the COOP to use to cover COOP expenses; and in ensuring favorable tax treatment under Subchapter T of the IRC. We will also not be able to depend on any financial assistance from DAS or its fundraising activities. This raises the issue of "start-up capital." Without that, the COOP will essentially be starting out in the red. I would encourage those who intend to remain members of the COOP to consider agreeing to a one-time investment in the form of a "one-time membership activation fee" of \$10 or so (which would also be applicable to any new COOP members as they come on board) in addition to the regular monthly membership dues. This initial investment would increase each member's equity interest in the COOP and would be redeemable at a set value when a member leaves the COOP and surrenders his or her membership certificate. This might help to raise a few hundred extra dollars for the new COOP to get off the ground quickly.

CONCLUSION AND GRATUITOUS OBSERVATION

The foregoing summarizes the basics of my findings following a full investigation of all available documentation, more particularly, it summarizes the three basic issues I have identified as being in need of immediate attention, as well as my recommendation for possible solutions to each and all of the issues identified. Obviously, we will find and fix the bugs and will need to hammer out the details over time but we can do that as we grow. These details need not delay the most important phase of my recommendation, which is to immediately incorporate the COOP as a separate Colorado Cooperative Association and cease all COOP activities through DAS.

While this new course may be frightening to each of us to some degree, I see it as an actual step closer to what I have come to understand as the "vision" of this

cooperative. For once, the members will actually have full authority over the structure and operations of the COOP through guaranteed voting rights as both members and directors. The COOP can actually create its own Bylaws and incorporate many of the ideals we all have been abiding by voluntarily into a legally binding document upon which the membership can completely rely. This is a golden opportunity for the COOP to actually pull together in a way it never has before with clear goals, direction and procedures that are truly adopted and aspired to by the COOP members. It seems somewhat ironic that it is the dramatic, possibly traumatic, and almost surgical separation of the old COOP from DAS that opens the way for both organizations to grow and thrive independently yet side-by-side, each with a solid foundation built upon the newfound unity of its respective members.

Thank you for this opportunity to be of service. I am happy to respond to any questions the Board or the members may have.