

TRANSFORMING THE DYNAMICS
OF NONPROFIT BOARDS:
From Passive to Active Agencies

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Executive Summary

The post Enron changes in the role and responsibilities of directors of public corporations have cast their shadow over the expectations for directors of not-for-profit organizations and will heavily influence what is deemed best practice on the part of nonprofit boards.

At the same time contributors to such organizations are increasingly pressing such organizations for greater accountability and transparency. In addition, corporate officials who join nonprofit boards are likely to challenge nonprofit organizations to adopt at least some of the reforms which have taken hold in the corporate sector.

As a consequence of these pressures nonprofit governance will be transformed; the foundation of nonprofit governance will be rooted in active, well informed directors who are committed to move the organization to conform to best practices. Ideally, the board of directors will act as the ultimate insurer that nonprofit programs actually advance charitable interests, generating definable benefits.

This paper describes this transformation and the new obligations nonprofit directors are challenged to assume. To discharge these modern day responsibilities the board must become an active rather than passive force, significantly changing the nature of board membership. An active board develops an independent sense of the organization's activities and how it is perceived by those it serves, helps frame the organization's agenda and conducts reviews to evaluate the efficiency and effectiveness of operations.

The directors' new role demands not only the conscientious dedication of time but also the determination to learn about the organization first hand, to push management beyond briefings, digging beneath the surface of things, sensitivity to the state of employee morale and an ability to direct attention to the pivotal issues that genuinely shape the direction of an organization.

The article outlines six critical areas in which the board can play a genuine leadership role and reviews the factors which can be expected to motivate board members to adopt a more proactive stance. It calls for making the minimum obligations of directors explicit and discussed the removing of an underperforming director.

Candidates for directorships of such organizations need to evaluate their readiness to serve in light of the prospective new level of responsibilities directors will face in the governance of nonprofit institutions

Introduction

A variety of personal motivations have traditionally drawn people to serve as directors of nonprofit organizations --- empathy for a charitable cause, the prestige of association with an elite organization, the opportunity for humanitarian leadership, relationship with prominent people, the importance of an organization within a community. Today nominees need to recalibrate their readiness to serve in light of the new level of responsibility directors must accept in the governance of nonprofit institutions. The post Enron changes in the role and responsibilities of directors of public corporations have cast their shadow over the expectations for nonprofit directors and will heavily influence what is deemed best practice on the part of nonprofit boards.

While for profit and nonprofit enterprises are structured differently with different motives the widely publicized and emulated reforms in the public corporate sector represent such a visible, more explicitly articulated standard of governance that it is hard for nonprofit boards to ignore, especially as corporate executives also act as nonprofit board members and contributors. [1] Business board members will challenge non profits why the public corporate standards should not be adopted. At the same time, contributors to such organizations are increasingly pressing such organizations for greater accountability and transparency with respect to the use of their funds. Mixed with cases of abuse in the nonprofit sector, and intensifying Congressional oversight of the tax treatment of nonprofits, leaders of the industry have publicly pressed for reforms modeled on changes in corporate governance. [2]

As a consequence of these pressures, nonprofit governance will be transformed; the foundation of nonprofit governance will be rooted in active rather than passive, impressively, not casually informed, directors, who are committed to lift the organization to conform to the best practices. The board will ideally act as the ultimate insurer that the nonprofit programs actually advance charitable interests, generating definable benefits, as opposed to supporting the organization's own administrative interests.

This article describes this transformation, the legal and practice environment which is shaping the obligations of nonprofit directors and the new role and responsibilities they are now challenged to assume. The model is the venture capitalist investor or private equity fund partner. [3]

The Governance Environment

The current environment is a product on the one hand of the failings of the *system* of public corporation governance and the absence of such a *system* in the nonprofit world.

The first years of this century have been marked by the efforts by securities exchanges and the federal legislature to curb the corporate abuses and shore up the system for protecting the public from the dissemination of misleading financial information.

Since the 1930s, the integrity of information disseminated to the public has been screened by the combined guardianship of boards of directors, their accountant and attorney advisors, stockholders, banks, credit analysts, state attorneys general and the SEC. The role of the board is compromised by the inherent conflict between shareholders-owners and managers who are to act as agents of the owners with board of directors charged with representing the interests of owners but who often, selected by management, give their loyalty to management. [4]

When the system failed in Enron and other cases, the market exchanges moved to shift power to independent directors and called for the creation of a series of committees which would govern the review of financial statements and internal controls, the nomination of board members and the compensation of senior managers. The thrust of the reforms was to strengthen the hands of the independent directors in running the corporation.

Sarbanes-Oxley ("SOX") went further and interjected the government into the internal processes of a public corporation and its relationship with its auditor; specifically, it required corporations to establish internal controls for financial reporting and then for senior officials to assess how effective the system is in practice. In addition, it requires the auditor to assess management's assessment of its internal control system changing the scope of accounting review by auditors. SOX also barred auditing firms from most forms of consulting with audit clients, seeking to end the incentive the firms may have had to place a higher value on lucrative consulting work than their audit practice and consequently exhibiting less resistance to earnings management by their clients. [5] SOX also ended the authority of accounting firms to set accounting standards for public corporations, vesting the power in the Public Company Accounting Oversight Board appointed by the SEC and empowered to audit the work of auditing firms, assessing them with fines as well as suspensions from practice. Finally, SOX requires the CEO of a public corporation to sign the company's financial statements undercutting the "I didn't know or get it" defense to the company's financial condition.

Proposals by various reformers to separate the CEO and Board Chair role, even to create a "lead director" position, have been slow to gain acceptance. CEO's still very much want to retain control over the agenda of their boards and thus the matters it addresses.

Despite these reforms occasions of executive sense of entitlement to personal enrichment continue. Two examples are the flagrant, widespread backdating of stock options and the lucrative exit pay packages, embellished with tax gross up provisions to circumvent the 1984 excise tax on excess deferred compensation. This has led even some businessmen to argue that further measures are required to deter such conduct. [6] Others would simply say that perhaps there is no systemic prophylactic for greed. It will always find a way to circumvent what defenses can be devised and the cost of compliance with such defenses adversely affects the competitive position of American business and capital markets against global competition.

Oversight of Nonprofit Organizations

In the case of nonprofit organizations, since there is no ownership interest, there is no division of financial interest between agent and owners to contend with. Rather the tension is between managers---and their stake in

their organization's welfare--- and charitable beneficiaries. In the best of worlds, managers would be regarded as essentially agents for their organization's charitable beneficiaries with oversight vested in the board of directors. However, there are no structural requirements imposed on an organization by SOX or the Exchanges, no new mandates for organization accounting, nor SEC or PCAOB oversight mechanisms.

There is marginal oversight in the form of occasional intervention by state attorneys general which are empowered to enforce the historic common law trust duties of care and loyalty and state tax exemption grants well as, in several states, the filing with their office of audited annual financial statements. The IRS also has a role in ensuring that tax exemptions are granted for genuine charitable purposes and that exempt organizations are operated for public, not private benefit. But the overwhelming burden of overseeing the integrity of charities rests with boards of directors; government acts, if it acts all, after the fact, not to prevent wrongful conduct. It is the board which can act before the fact to ensure that the organization is operated to serve its exempt purpose and in a manner which actually advances the welfare of society. The board is also on line to see that senior management receives reasonable but not excessive compensation. It this *power to prevent* wrongful conduct which makes the board role pivotal. [7][Better Business Bureau Wise Giving Alliance]

In addition—and perhaps most critical of all—there is the duty to satisfy the mounting demands for accountability—the objective demonstration of outcomes that justify the mission of the organization and its special tax status. Claims that such outcome analysis is difficult to produce will no longer suffice. The board has no greater obligation than to find the means and methodology to satisfy such demands. Responsibility, then, for the governance of nonprofits, like a higher beam, is pointed at the board of directors.

II The Passive Director

Traditionally, to be asked to become a board member was perceived more as honor than a responsibility, thereby setting the tone for the director's performance on the board. Fram analyzes two studies of corporate directors, observing that "simply stated the directors in the two studies recognize there are risks to being on boards, but they are more prone to look at the rewards. They tend to look to the directors and officers' liability protection to provide adequate financial protection", a potentially risky proposition as discussed note below. [8]

A particularly disturbing finding is that "the type of information needed to help boards avoid disaster is not getting to directors. Managements are not doing an adequate job of delivering vital information on changes to their internal financial controls. And apparently board members are not demanding the information."

Fram observes "this adds up to a modest change in board environment at a time when most people assume a great deal is happening" citing New York Times writer Gretchen Morgenson (May 16, 2004) observation that "boards seem to be taking a 'business as usual' stance."

My own perception of nonprofit boards is that they, if anything, too often are not activists, have not learned the business of the organization and thus continue to be generally passive recipients of often bland reports by management, uncritically accepting the organization's financial status, rarely striking at the heart of a presentation or asking probing questions or insisting a new direction be examined. There is little realistic evaluation of the organization's strengths and weaknesses or challenge to the status quo. Too frequently, routine prevails and board meetings are conducted in a state of non-contentious fellowship.

Fram, rightly it seems to me, concludes: "Both the business and nonprofit worlds have a long way to go to attain broad governance reform".

III Changing the Board Dynamics: From Passive to Active

To discharge its modern day responsibilities, the board must be transformed from a passive to an active agency, significantly changing the nature of board membership.

An active board develops an independent sense of the activities of the organization and how it is perceived by those it serves, helps frame the organization's agenda, conducts the reviews necessary to evaluate the effectiveness and efficiency of operations and infuses a value system and consciousness into the organization.

The new directors' role demands not only the conscientious dedication of time, often at inconvenient moments, but also the determination to learn the story first hand on the ground, to push beyond management briefings, digging beneath the surface of things, to be aware of the state of morale of the staff, and able to direct attention to the pivotal issues that genuinely shape the direction of an organization. It calls for the art of building support in the face of inertia, conflicting outlooks, and uncertainty about change; it calls for persistence in the face of sharp resistance, of not just going along but the taking of a sharp position which may fail to prevail. As a price of admission and influence, more and more, directors are expected to contribute and raise money annually, with a reciprocal obligation to those whose gift they solicit. It is the role of a durable, very engaged stakeholder akin to the role of private equity investors whose capital and reputational stake encourage working to turn around potential failures rather than early withdrawal. [9]

An effective board can be seen as having two core functions: (1) a fiduciary role in ensuring compliance with law and best practices preserving the essential integrity of the organization—a role that has become more complex and demanding in the post Enron era, and (2) a strategic role helping to guide the organization in building its capabilities to accomplish its mission--- a role venture capitalists and private equity investors see as their primary focus [9a] but they in fact are complementary roles and an organization is best served when both command board attention.

A board so constructed will play a genuine leadership role in areas critical to the success and continuing viability of the organization:

*A pro active strategic role, assessing the organization's strengths and weaknesses, its capabilities to expand its program, framing the pivotal

strategic issues and prompting the organization to undertake a plan which addresses them and lays out a path to enhance the performance of the organization including the acquisition of the personnel and capital resources necessary to achieve the plan's goals.

*Meaningful financial oversight ensuring that financial statements and reports are prepared with meticulous care, presenting a realistic picture of the organization's financial condition, reviewed by an audit committee composed of directors with financial acumen and no ties to staff or the organization's auditor and then read and understood by all board members. The Board audit committee should select and draw up the contract with the auditor spelling out the scope of the accounting the firm is expected to perform and its obligation to promptly inform the committee of any questionable practice. Inquiry should also be made how the accounting firm resolves internally questions of interpretation of the applicability of accounting rules to the organization's financial reports. [10]

*Close attention to the organization's compensation system, process and awards including how it compares with other comparable organizations and the relationship of remuneration to performance benchmarks. Review here must encompass health care and pension plans, two of the most costly obligations of any organization. The board must determine the balance between making available benefits in the form most appealing to employees and affordability. And throughout its review the board wants to gain a clear sense of the equity in all aspects of the organization's compensation structure. The initial review work is best done in the committee format and if affordable at all, expert advice should guide the committee with respect to both the choice and administration of health and benefit plans.

*Creating a transparent process for nominating and electing board members pursuant to criteria for membership established by the board which identify the skills and experience that should ideally make up the composition of the board. The process for selection and election should insulate the organization from any one person or clique exercising undue influence over the make up of the board.

*Establishing the cost effectiveness of the organization's programs through documenting, in reasonable detail, that the maximum available funds are expended on programs as opposed to administration. The analysis should encompass an independent assessment of the outcomes that result from such expenditures and the costs of delivering them compared to the costs incurred by other organizations in operating comparable programs. How effective and efficient the organization is in deploying its resources is the litmus test of the value of the organization and documentation available publicly is the heart of accountability. Nonprofits, under the active supervision of their boards of directors, need to *account* for the extent to which they satisfy these justifications for the tax benefits accorded such organizations. Without such showing the diversion of potential tax revenues for the benefit of private organizations cannot be sustained. [11]

*Set the agenda of board meetings with input from the executive director and his/her staff. The items brought before the board will directly influence what the board knows and considers about the organization and

whether it has the opportunity to affect policy and operating decisions in a timely manner.

An illustration of the harm that can result from an insufficiently engaged board is the

American University case. An apparently inattentive board was unaware of the President's spending habits. His salary was \$633,000 but in addition he spent nearly \$400,000 in University funds on his personal life style. He also failed to pay the income tax due on the expenditures which could not be legitimately defended as University business. The story broke in the Washington papers, where the University is situated, and an embarrassed board had to discharge the President, seek recovery of monies due the University and testify, mea culpa, before the Chairman of the Senate Finance Committee to the reforms the board adopted in the wake of the scandal

In contrast to the lax American University board, employing directors to bring about positive change in the academic programs of colleges and universities is the surprising recommendation of former Harvard President Derek Bok. Boards of trustees traditionally avoid any interference with academic programs. Bok, however, urges boards to prompt university leadership to establish a continuous system of evaluating the effectiveness of undergraduate education and to develop innovations in teaching methodologies. In cases in which faculty resistance to such experimentation is strong, departure, in his view, is warranted from the classic principle that trustees do not interfere in academic matters. Bok argues that such intervention is necessary and appropriate " so long as trustees do not try to dictate what courses should be taught and what instructional method employed but merely to ask for reports on the procedures used to evaluate academic programs and encourage innovation. It is surely within the prerogatives of the board to take an interest in these activities and to urge the president to work with faculties to develop a process designed to ensure continuing improvement in the quality of education." [11a] Bok's view of boards seeking to affect change, even in new arenas, is a harbinger of the future.

IV Making Minimum Expectations Explicit

Holding a board to high standards is aided immeasurably by declaring in writing, preferably in the organization's by-laws, directors most critical duties. A nonprofit wanted to reduce the size of its board eliminating a number of directors who no longer contributed financially , whose meeting attendance was erratic and when present they became carping critics turning board meetings into divisive struggles accomplishing little. Outside of board meetings they conveyed negative views of the organization to anyone who would give them an ear. But board members could be removed only by a vote of the full board ; there was no mechanism for the nomination of board members against pre-established standards, the application of the term limits would have eliminated productive and nonproductive members alike, and there were no declared attendance or financial contribution requirements. Here was a case of a board virtually paralyzed by the absence of standards of conduct spelled out in writing in the organization's by laws or minutes.

The adoption of by-laws creating audit, nominating, and compensation committees, and their respective responsibilities, are necessary to their establishment as instruments of governance. Incorporating in the by-laws any

minimal expectations of financial contributions and attendance by board members avoids conflicting memories as to what, even if any, requirement has been adopted. Director's responsibility for being fully informed about the organization's strategy, financial condition, compensation practices, especially the cost effectiveness of its programs, and to act with good will toward the organization should be made explicit; writing it down turns a hortatory list of good intentions into a code of acceptable conduct.

Directors should be fully cognizant of their responsibilities from the start of their terms---learning of them after the fact of some breakdown in the organization is too late and defeats the role of the board as empowered to act before the fact, to prevent organizational error. Orientation sessions for new directors are surely useful but the most powerful message will be the black and white of the written word.

Nonprofit by-laws do not typically set out the duties of directors in the manner suggested here. But such by-laws would help, by a process of self selection, weed out from membership those who in fact would not bring the requisite dedication to the board. Where it unfortunately becomes necessary to remove a director involuntarily such by laws provide a foundation for doing so. Thus, by-laws with clear statements of director responsibility become important instruments in building the cohesion and effectiveness of an active, dynamic board.

V Forces for Change

The challenge is to motivate board members on a widespread basis to become active and involved leaders. One factor that may sway some is that the best defense to law suits and personal criticism is to be fully knowledgeable about the operations of an organization of which you are director. There is no foolproof insurance against complaints or even law suits against directors. [12] But the best defense, one that is widely recognized in law, is that I conscientiously exercised by my best judgment, albeit it may not have been, in hindsight, the " right" one.[12] In any case, being out of touch as a director offers little excuse, to colleagues or complainants.

What is going to motivate board members to adopt a more proactive stance, especially since it will only increase the demands of the job for which of non-foundation directors receive no financial compensation? [Bowen]

A series of factors is likely to move boards in this direction.

First, the experiences of those whose passivity allowed serious wrongful conduct to occur and then were compelled to take steps that would have been wiser to take to prevent the offending conduct. American University officials, in testifying before the Senate Finance Committee stated: "In the fall 12.2004, the Board of Trustees approved the 2005 Internal Audit Plan, which included using a significant portion of internal audit's time to begin Sarbanes-Oxley type review of the university's internal control of financial processes. Although Sarbanes-Oxley essentially does not apply to not-for-profit institutions with two exceptions[], the Audit Committee concurred with a recommendation from management that the University should be highly proactive in applying rigorous internal control standards across the enterprise." American University

American University, having explicitly opened the door for SOX to the nonprofit world, it isn't likely to be close it again. Other institutions can be expected to follow suit in applying the principles of SOX to the nonprofit world as recommended by the ABA Coordinating Committee on Nonprofit Governance, Guide to Nonprofit Governance in the Wake of Sarbanes-Oxley and the Panel on the Nonprofit Sector, Strengthening Transparency Governance Accountability of Charitable Organizations, a final report to the Congress and the Nonprofit Sector., June 2005

An even more powerful voice in favor of changing the dynamics of the Board will be

that of business executives who live with the reforms in corporate governance. Despite some frustration with some reforms [13], they are likely now to perceive nonprofits as warranting the same extensive board scrutiny they are obligated now to apply to public corporations.

Certainly major contributors, individual and institutional donors, can also press boards to take a more active role, especially to ensure that the organization meets tests of accountability and transparency and can defend its cost structure. Indeed, the presence of such active board leadership should be a condition of their funding and they can also sponsor programs for new board members outline the new role and responsibilities of such directors. The Ford Foundation in its Primer for Endowment Grantmakers (March 12, 2001) writes that one of the key qualification for an endowment grant is "an active and diverse board that truly governs the organization" (p 7) Tuckman and Firstenberg similarly suggest a critical factor in determining eligibility for endowment and venture grants is a board "composed of members who are actively dedicated to the organization and who have demonstrated that they provide effective leadership, ensuring the organization complies... best practices." [14] Foundations and educated private contributors, then, have a genuine opportunity to foster a movement toward a new kind of board leadership.

One can also expect the Attorneys General of major states to pay more attention to nonprofit transactions.

Accordingly, forces are at work to bridge the divide in governance between for profit and nonprofit enterprises applying the best practices to both sectors.

[1] Eugene H. Fram, Governance reform-Its only just begun, Business Horizons 47/6 November-December 2004 (10-14)

[2] Strengthening Transparency, Governance, Accountability of Charitable Organizations, Report to the Congress and Sector of the Panel on the Nonprofit Sector (June 2005); Guide to Nonprofit Governance in the Wake of Sarbanes-Oxley, ABA Coordinating Committee on Nonprofit Governance (2005);

The Sarbanes-Oxley Act and Implications for Nonprofit Organizations, BoardSource (2003).

[3] "Venture investors are by no means passive investors; they take a proactive stance in guiding, leading and nurturing the companies in which they invest." Paul B. Firstenberg, *Philanthropy's Challenge Building Nonprofit Capacity Through Venture Grantmaking*,

The Foundation Center (2003) p.13. Private equity funds, while investing at a later stage of a business's evolution than venture capitalists, adopt a similar posture of active and continuous engagement with the companies in which they invest." *Philanthropy's Challenge*, p.9. "Unlike the owners of public companies, who tend to be too remote and thinly spread to spend time and money closely monitoring a business, private equity firms have big stakes. Because their people's careers are on the line they have a powerful incentive to keep a close eye on things." *Briefing Private Equity The Economist*, February 10th 2007 pp 75-76.

[4]Paul B. Firstenberg and Burton G. Malkiel, "The Twenty-First Century Boardroom Who Will Be in Charge?" *Sloan Management Review*, Fall 1994 ,38 M.C. Jensen and W.H. Meckling, "Theory of the Firm: Management Behavior, Agency Costs and Ownership Structures," *Journal of Financial Economics* (1976)

[5] John C.Coffee, Jr *Gatekeepers The Professions and Corporate Governance* Oxford (2006)

[6] John P. Bogle, *The Battle for the Soul of Capitalism* (Yale 2005)

[7]The role of attorney, serving either as in house general counsel or outside counsel, could be strengthened by being granted an express mandate from the board of directors to review an organization's compliance not only with the law but also best practices. Such a role, proposed by a Task Force of New York City Bar Association, would have to be reinforced by ready access to the board whenever counsel deems it necessary. The Task Force also calls for an amendment of ethical rules permitting counsel to disclose to regulatory authorities fraudulent conduct by a client. New York City Bar Association Task Force Urges Stronger Role for Lawyers in Corporate Governance. Forty-Fourth Street Notes January 2007. More support for sound governance could also be provided by the accounting firm which audits an organization's financials. A draft of the audit is usually presented at a meeting with the audit committee together with a draft of a "management letter" setting forth recommendations for improvements in accounting practices. Such a letter and its discussion with the audit committee present an excellent opportunity for an exchange of ideas with the board audit committee on steps that could be taken to strengthen governance practices.

[8] Fram. supra

[9] "Companies with smaller boards...and larger equity holdings...outperform their counterparts....Our results do not suggest that more outside directors lead to improved performance but that outsiders often resign from the board instead of challenging managerial shirking. We conclude that choosing directors for whom board exit will be costly will better reduce agency

costs." William O. Brown and Michael T. Maloney, *Exit, Voice and the Role of Directors: Evidence from Acquisition Performance* (1999)

[9a] Tom Perkins, "The Compliance Board," Wall Street Journal, March 2, 2007 p. A17

[10]The basic document all tax exempt charities must file with the IRS is Form 990; it requires statement of "accomplishments" of four largest programs measured by expenses and combined information for remaining programs but no review to ensure it has specificity require or activities of evaluation of degree of success or failings---"accomplishments" doesn't really touch on "quality" of individual programs or require analysis of "outcomes" of programs against objectives or organization's overall performance; organizations should prepare real outcome analysis available to public but also for own benefit. For example the Miami Dade Community Foundation lists grants made but not what results grants produced. Review should be conducted at least bi- annually and with use of independent consultant if the organization afford it or get a grant for it and Audit Committee should approve scope of review and results and then report to full board. Panel recommends each organization "to share more detailed information about its programs through an annual report or other appropriate document that is available to the public on the same basis as Form 990" and to post such information on their websites

[11] Managing for Profit in the Nonprofit World, The Foundation Center (1986) pp 13-14 Bittker and Rahdent, "The Exemption of Nonprofit Organizations from Federal Income Taxation," The Yale Law Journal, vol. 85, no.3 January 1976

[11a] Derek Bok, Our Underachieving Colleges, Princeton University Press (2005) p. 334]

[12] Business Judgment rule

[13] R. Glenn Hubbard and John L.Thorton, "Action Plan for Capital Markets," Wall Street Journal, November 30, 2006 p. a16.

[14] Paul B. Firstenberg and Howard Tuckman, "The Criteria for Endowment and Venture Grants: Increasing Access to Capital by Nonprofits," submitted to Arnova, November, 2006. See also High Engagement Philanthropy: A Bridge to a More Effective Social Sector, p. 18, Venture Philanthropy Partners & Community Wealth Ventures (2005)