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No Profit Doesn't Mean No Problem

Boards of directors at nonprofit organizations also face legal challenges.

By Stephanie Tsacoumis

Nonprofit organizations may not need to worry about meeting Wall Street's quarterly earnings expectations, but they still face legal challenges of internal governance—challenges that in many ways are more complex than those of for-profit companies.

Although WorldCom and Enron are prime examples of corporations manifesting governance deficiencies, nonprofits exhibiting governance shortcomings also have been prominent:

- The board of trustees of Vanderbilt University began monitoring the chancellor's spending after discovering that more than $6 million was spent to renovate the chancellor's university-owned mansion without the board's knowledge or approval. One trustee acknowledged that the board's supervision of the chancellor probably was "a little loosey-goosey."

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- The Nature Conservancy adopted significant governance improvements after allegations of questionable transactions with insiders, valuation abuses on gifts of conservation easements, and other inappropriate practices.
- The president of American University resigned after auditors questioned more than $500,000 in expenditures apparently for personal purposes.

Additional regulation of nonprofits has been proposed at both the federal level and the state level. The Senate Finance Committee has pursued governance reforms for nonprofits, and several other congressional bodies have recommended reforms.

States also have taken action. The California Nonprofit Integrity Act of 2004 imposed on certain nonprofit entities requirements similar to those imposed on public companies by the Sarbanes-Oxley Act. Likewise, various state attorneys general, charged with supervising charities and protecting the public interest, have proposed applying elements of Sarbanes-Oxley to nonprofits.

More Complex

In many respects, the governance issues facing nonprofits are more complex than those of for-profit entities. First, while for-profit corporations have a single constituency (stockholders), nonprofits often have multiple constituencies. These constituencies may include donors, those served by the organization, members, those who elected the board, volunteers, and other constituencies (such as state attorneys general) who may hold the directors accountable.

Second, while for-profit boards can focus primarily on enhancing stockholder value, nonprofit boards must be committed to the organization's mission. Neither profits nor business considerations alone will guide nonprofits. Also, unlike for-profits, nonprofit organizations have responsibilities for fund-raising and dealing with volunteers.

Third, nonprofit organizations encompass extraordinary diversity. Nonprofits include labor unions, foundations, schools, social clubs, trade associations, professional sports leagues, religious organizations, civic organizations, hospitals, and recreational institutions. Some are membership organizations; some are not. Some have billions in revenue and thousands of employees; some struggle to pay postage and rely entirely on volunteers. Many employ a federated structure with a national organization and local affiliates or members.

Relevant Issues

Nonprofit governance reflects the great variety in types, structures, and missions of nonprofits. The model adopted by any nonprofit organization should reflect its mission, the size and scope of its activities, and its needs and characteristics.

Nevertheless, some legal issues are relevant to almost all nonprofits.

Fiduciary duties. All governance structures and procedures are

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predicated upon a uniform backdrop of fiduciary duties. Nonprofit board members have fiduciary duties of care and loyalty.

The duty of care requires that a director be reasonably informed, participate in decisions, and do so in good faith with the care of a prudent person in similar circumstances. A duty of obedience to pursue the organization's mission is part of this general duty of care.

Like for-profit directors, directors of nonprofit organizations enjoy the protection of the business-judgment rule, often known in the nonprofit context as the best-judgment rule. Under the rule, courts will defer to director judgments made on a reasonably informed basis, in good faith, without a conflict of interest, and with a rational belief that the judgment is in the entity's best interests.

The duty of loyalty requires directors to act in the best interests of the corporation, not in their own interests or the interests of someone else.

Board role. The appropriate role of the board of directors is oversight rather than management of day-to-day business. The board should establish long-term objectives and policy and delegate daily operations to management. Yet effective board members are informed, active, and independent-minded. They are not figureheads, nor are they rubber stamps.

Board size. As is generally recognized in both the nonprofit and for-profit sectors, smaller boards are more effective. Smaller boards encourage more active participation from each member. While some nonprofits gravitate toward larger boards for fund-raising purposes or to ensure diversity, large size can impair board efficiency and effectiveness. One approach that fosters fund-raising while preserving an effective governance structure is to establish an advisory board of significant donors, reserving governance functions for a smaller oversight board.

Some experts suggest an optimal nonprofit board size not exceeding 15 members. Median board size among nonprofits in one 2004 survey was 15 members. Several large nonprofit organizations that recently studied their governance practices concluded that smaller governing boards were desirable. The Nature Conservancy reduced its board from 40 to 21 members, the United Way reduced its board from 50 to a range of 20 to 40, and the American Red Cross intends to reduce its board size from 50 to a range of 12 to 20.

Accountability. The board of directors is ultimately responsible for the oversight of a nonprofit corporation. Although responsibilities and duties may be delegated, the board may not entirely abdicate its oversight obligations. Accountability is imperative. The board should regularly assess both itself and management, and it should rectify any identified shortcomings.

Independence. Publicity about conflicts of interest involving nonprofit entities and their directors and officers has reinforced the importance of independent boards of directors. Cases of excessive compensation and corporate waste, as well as transactions benefiting board members, staff, and other interested parties, have resulted in the view that a significant portion of a nonprofit's board should be independent. In its report to Congress, for example, the Panel on the Nonprofit Sector recommended that at least one-third of a nonprofit's board consist of independent members.

Independent directors in the nonprofit sector are generally understood to be those who have not received any compensation or material benefits from the organization and who are not related to recipients of such compensation or benefits. Some nonprofit organizations have detailed independence standards similar to those of public companies.

Conflicts of interest. Conflicts of interest also present concerns. One publicized case involved Adelphia University's purchase of insurance through a brokerage firm owned by a trustee. Neither the material terms nor the benefits to the trustee were disclosed to the board.

To prevent such situations, conflicts of interest should be disclosed and evaluated by disinterested directors against a rigorous standard. Directors and officers should affirm in writing, on an annual basis, their understanding of the organization's conflict-of-interest policy. They also should disclose all known actual and possible conflicts involving them or their family. If a transaction with an interested party is approved, directors should document how the transaction compares with an arm's-length transaction. They also should document why the interested-party transaction furthers the organization's mission and interests.

Audit committee. Every nonprofit board should seriously consider an audit committee. Beyond that, every nonprofit (1) with significant financial resources or operations, or (2) that has its financial statements audited, should establish an audit committee. California law mandates an audit committee for certain large nonprofits, and several other states have adopted or proposed similar requirements.

The audit committee should select the auditor, review the auditor's opinion and management letter, review the financial statements with a focus on internal and financial controls, and oversee matters involving the auditors and financial statement presentation. Members of the audit committee should be independent and financially literate.

Compensation committee. Nonprofit boards—like those of their for-profit counterparts—generally are empowered to appoint officers and employees and to fix their compensation. Since the compensation of United Way's former President William Aramony was questioned in the early 1990s, appropriate compensation levels for nonprofit executives have sparked controversy and legal action. For instance, Richard Grasso, the New York Stock Exchange's former president, has been sued for restitution of more than $100 million in compensation awarded when the exchange was a nonprofit. Regulators perceived that the board did not employ appropriate governance procedures relating to Grasso's compensation. Not only can unjustified compensation raise duty-of-care issues, excessive compensation could jeopardize the organization's tax-exempt status.

Unlike corporations in the for-profit sector, whose results generally are measured based on profitability, nonprofit entities lack empirical performance measures. As a result, compensation criteria in the nonprofit sector are elusive and require careful consideration.

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Executive compensation either should be approved by the full board or by a compensation committee consisting of independent directors. The executive in question should not attend compensation-related discussions and deliberations. Compensation decisions should be made, to the extent appropriate, with information about the compensation of similarly situated executives or input from outside compensation consultants.

Whistle-blower procedures. In recent years, all types of organizations have adopted whistle-blower processes either as a Sarbanes-Oxley requirement (in the case of public companies), as a result of the Federal Sentencing Guidelines, or simply as a matter of good practice. Additionally, Sarbanes-Oxley makes it a crime for any organization—nonprofit or for-profit—to retaliate against a whistle-blower.

The core of whistle-blower procedures is the establishment of a mechanism outside normal reporting channels to permit communication of concerns without fear of retaliation and with the expectation of an appropriate response. Because such concerns may involve financial abuses or fraud, the audit committee often oversees whistle-blower processes. To prevent this from becoming overwhelming, however, specific criteria about the complaints to be reported to the audit committee (and then to the board) should be established.

Nonprofit organizations have their own complex governance challenges, but often practices borrowed from the for-profit sector—such as smaller oversight boards, independent audit committees, and whistle-blower programs—can be applied appropriately in the nonprofit sector.

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