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Sweet Charity?

Ten Things to Consider Before Joining a Nonprofit Board

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CORPORATE EXECUTIVES OFTEN VOLUNTEER to serve on nonprofit boards with the very best of motives. They want to “give something back” or otherwise serve the common good. But in an environment where board members of all sorts of institutions are under unprecedented scrutiny from regulators, stakeholders, and the public, would-be directors should beware that, in some cases, their altruism might lead them into controversy.

What, then are the factors that the diligent candidate may wish to consider before joining a nonprofit board? Before a business executive accepts an opportunity to serve as a nonprofit director, it is appropriate to ask certain questions concerning the organization’s governance and operations. The director candidate shouldn’t be shy about doing so, since the savvy nonprofit will undoubtedly be asking some basic questions of the candidate as well. The following criteria should help:

Mission. “Mission” is what it’s all about—the reason a candidate is considering board service. So it becomes vitally important that the candidate understand the essence of the organization’s charitable mission and focus and how they are manifested—in its articles of incorporation, in its mission statement, and in periodic mission effectiveness evaluations. Also important is the extent to which the organization monitors the relationship of its operations to its mission. A nonprofit director owes a duty of loyalty to the charitable mission of the organization, so the candidate must not only understand that mission, but must be willing to embrace and support it as well. If the candidate feels any hesitation at this fundamental level, it may be best to take a pass.

The Business Model. While a charitable corporation is not formed as a profit-making enterprise, it must sustain itself financially. It is a part of a director’s duty of care to oversee the business and financial aspects of the charity. As a fundamental inquiry, the candidate must become familiar with the business model of the charitable organization. What is the source of the organization’s operating revenues? How stable is that source of revenue? Is it subject to cyclical developments due to the nature of the principal payors, such as government or grantors? Of what importance is investment income to financial stability? How dependent is the organization on charitable solicitations? Warning signs include a habitual struggle to break even, an extraordinary dependence on charitable donations, or operation in a highly competitive environment.

Corporate Finance. Not every director must be a “financial expert,” or come from a business background. Nevertheless, there is an increasing focus on the financial literacy of a director—specifically, the ability to read and comprehend a balance sheet—as part of a core level of fiduciary competency. The candidate should be comfortable that he can interpret the organization’s financial statements and other key financial documents. Furthermore, the candidate should become familiar with the financial history of the charity and obtain assurances with respect to its financial stability. Notable red flags would be prior restatements of the charity’s financial statements or an Internal Revenue Service or state charities bureau audit.

The Potential for Conflicts. After becoming familiar with the charity’s business model, the candidate should evaluate the potential that conflicts of interest may arise based upon the candidate’s own material financial or nonfinancial relationships. Conflicts will periodically arise

in a diverse, sophisticated charity board, and their presence alone should not be cause for concern as long as they are properly identified and reviewed. Rather, the problem arises from conflicts so fundamental to the business of the charity that were the candidate to become a director, he or she would essentially be “disabled” from meaningful service because of the scope and severity of the conflict. No problem at a charity attracts the attention of the media and regulators as much as the suggestion of unresolved conflict of interest or self-dealing.

Corporate Structure. The candidate should have a working knowledge of the basic corporate structure of the charity. It is a stand-alone organization? What type of legal entity is it—a nonprofit corporation, unincorporated association, or other structure? Does it have “members”—that is, a controlling body of persons or a corporation authorized by state law—who exercise reserved powers over the charity? Are there any affiliates or subsidiaries that control the charity, or that the charity itself controls? What is the nature of its tax-exempt status? The candidate should seek assurances of the organization’s “good standing” with both the Internal Revenue Service and the state corporations bureau.

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Corporate Governance. In this “corporate responsibility” environment, it’s particularly important for the candidate to understand the charity’s governance. What is the constitution of the board? How are board members selected? What educational, professional, and other diversity is reflected in board membership? Who are they key members of the executive leadership team, and what are their respective roles and relationships? There are many basic similarities between governance of for-profit and nonprofit organizations, so the candidate should be attentive to the typical warning signs: an improperly sized board, a lack of qualified directors given the organization’s sophistication, or a board that is subservient to a dominating chief executive.

Oversight. The candidate should also evaluate how the board carries out its oversight function. Favorable signs include the exercise of constructive skepticism of management by board members, as reflected in the board minutes; fiscal controls; such as a discrete audit committee (increasingly common among larger nonprofits); board approval of annual budgets; an up-to-date conflicts of interest policy; and regularly scheduled executive session meetings of the independent directors. Does the board have regular access to officers other than the CEO, and to outside advisors? Does board control rest in a majority of disinterested directors? Is the CEO’s compensation “reasonable” in comparison to that of CEOs of similar organizations? Is compensation set by independent directors? How much authority is delegated to the executive committee? To what extent has the board considered the “best practices” emerging post-Sarbanes-Oxley?

Compliance. Nonprofit organizations today are subject to increasing governmental regulation at both the state and federal level (e.g., from state charity officials and the Internal Revenue Service). The candidate may wish to speak to the charity’s general counsel concerning the organization’s legal risk profile and its compliance program.

Independence. Joining the board of a charity may affect the candidate’s status as an independent director of another organization. If the organization’s donations to that charity exceed a certain proportion of the charity’s annual gross receipts, the director could be reclassified as “not independent,” depending on the definition adopted by the organization.

Insurance/Indemnification. Almost every sophisticated charity maintains liability insurance coverage and indemnification rights for its officers and directors. Nevertheless, it is prudent for a candidate to review the extent and sufficiency of this coverage. Key insurance-related areas to evaluate include:

- the scope of coverage and exclusions from coverage, such as self-dealing or “bad faith”;
- whether it is a “wasting” policy, in which the costs of defending a case are deducted from the total coverage;
- the presence of “duty to defend” provisions, which constitute a contractual commitment from the insurer to defend and indemnify the director; and
- the practice of renewal of “claims made” coverage: whether the coverage purchased for the current year covers claims made in the year (and not necessarily acts committed in the year).

With respect to indemnification rights, the candidate should know from what point the indemnification is provided: (a) whether it is active only where the director prevails; (b) how the indemnification approval process works; (c) whether indemnification is mandatory or permissive according to the board’s discretion; (d) whether it covers costs of defense; and (e) whether there are exclusions from the indemnity.

Faced with the realities of increasing oversight obligations, many qualified individuals are reducing the number of boards on which they are willing to serve. But asking the right questions up front will help to make serving on a charitable board a less risky and more rewarding opportunity.