

Trustee

Internal Investigations: The Role of the Nonprofit Board

By Michael W. Peregrine and Russell Hayman

At some point in its tenure, the nonprofit board may be faced with a controversy that will require it to conduct an internal review or investigation to resolve the issue. The specific controversy could arise from a number of sources—accounting/financial, compensation, regulatory compliance, employee relations, conflicts of interest, etc.

However, the source of the controversy is less important than the manner in which the board responds. In the current corporate responsibility environment, the expectation is that the board of directors will respond to its core fiduciary obligation to investigate “red flags” that affect the organization.

Following are suggestions on how the nonprofit board may do so.

Like their for-profit counterparts, directors of nonprofit organizations are charged with fundamental fiduciary duties of care and loyalty that obligate them to four fundamental tasks with respect to red flags: evaluate and respond with requisite process to reasonably available material information; act in accordance with the best interests of the organization and its charitable mission; act when there is a known duty to act; and do not act with an intent to violate applicable law.

In other words, the nonprofit board must attend to potential red flags that jeopardize the organization’s legal profile, respond in a good-faith manner, and take such action as the circumstances warrant to protect the charitable mission of the organization.

So, when confronted with a red flag or other similar controversy, how should the board respond? Here is a “roadmap” for trustees to consider:

1. Getting Ready. Prudent planning for such an untoward development requires that the board confirm the presence of an effective internal reporting system. Simply put, the board must assure itself that it is in as good a position as possible to learn of problems as they arise. Employees, key contractors such as physicians, outside vendors and professional advisors such as accountants, compensation consultants and legal counsel, all must have vehicles through which to communicate their concerns internally about potential illegal or otherwise improper activities that may present a material risk to the organization.

Examples might include internal compliance “hot lines,” whistle-blower protection policies, “reporting up” protocols with internal and external counsel and auditors, coordinated outside counsel engagements with the general counsel, effective reporting from board committees, broad board distribution of the auditor’s management letter, and executive sessions of independent members of the board, with and without counsel.

In this regard, there should be an explicit understanding with senior executive leadership of the need to advise the board promptly of potentially problematic conduct by the organization or one of its internal constituents. The board must be empowered to exercise its oversight obligation when circumstances so warrant. The board’s mandate to create an internal “culture of compliance”

requires that it ensure all corporate constituencies have a means to communicate concerns with corporate or employee conduct.

2. To Investigate or Not? This is not as obvious a question as it might seem. When presented with a yellow or red flag, the board must exercise judgment and discretion to determine the course of events. Not all incidents of potentially inappropriate activity require a board-directed investigative response.

Even in the current environment of corporate responsibility, an internal review or investigation is not always the correct or, at least, immediate response. The board must weigh materiality, the credibility of the information, potential cost of the legal process, risk of harm to the organization's reputation and to implicated individuals, and the presence of pre-existing internal procedures capable of addressing the matter. The advice of (nonimplicated) executive leadership, general counsel and outside professional advisors should be sought before a decision is made to proceed with an investigation.

3. Moving Forward. Assuming the decision is made to proceed with the internal review or investigation, the board should first decide who or what body should be responsible for managing the investigation on its behalf, and secondly, determine the reporting obligations of that party.

There are typically several choices of appropriate parties to manage the investigation, including: the full board of directors (although it is often too large and unwieldy for this purpose); a standing committee of the board comprising members with expertise and judgment relevant to the issue at hand (e.g., audit, governance, compliance); a special committee formed for the specific purpose of conducting the investigation; or executive leadership.

Key considerations are the independence of the reviewing body/parties, their potential conflicts of interest, the materiality of the underlying issues, cost, time sensitivity and expertise. It should not be presumed that the chief executive officer is precluded from leading the investigation. Indeed, there are likely to be many circumstances in which the CEO (where not personally implicated) is the ideal person from an organizational standpoint to manage the efforts, in close coordination with the general counsel.

The board may not, however, want the general counsel to be directly managing—as opposed to facilitating—an investigation involving executives to whom he or she may report. Under all circumstances, the decision on who should manage the investigation should be made with the advice of counsel as, in certain circumstances, the decision may have significant implications on the ultimate credibility of the process, particularly with regulators and, unfortunately, the media.

The reporting relationships of the party leading the investigation must be clear. The full board should be, at the conclusion of the process, fully informed as to basic facts underlying the investigation and its findings. It may not, however, be necessary for the full board to be informed about the day-to-day progress of the investigation, particularly if the process is being directed by a board committee. More constant reporting to an oversight committee that could brief the full board may be recommended if the investigation is being led by executive leadership.

4. Conducting the Investigation. Selecting appropriate counsel to conduct the day-to-day aspects of the investigation is a crucial board decision. This is an area in which the board has broad discretion, as there are few, if any, clear restrictions on the type of counsel that should be selected. Prudence suggests, however, that the board should work closely with the general counsel in terms of the selection process.

Factors to be taken into consideration include the counsel's investigative experience, familiarity with the applicable law, potential conflicts of interest, familiarity with the organization and with the subject of the investigation, and the extent of the counsel's prior representation of the organization, particularly with respect to the subject matter of the investigation. In this regard, the organization's general counsel can play an enormously valuable role advising the board on its choice of counsel, and/or other professionals, such as forensic accountants.

5. Defining the Scope. There are many important reasons for those managing the investigation and outside and general counsel to work closely together in defining the scope and limitations/term of the process. If not properly managed, an investigation can "take on a life of its own," with the potential to become extraordinarily consuming in terms of time, cost and human resources.

The board and counsel must move quickly and with precision to identify the specific goals and objectives of the investigation. There must be a clear understanding of when it is appropriate to conclude the investigation, as well as for the need for interim reporting. However, investigative counsel must be able to request a continuation or expansion if the circumstances warrant. Nevertheless, the scope of the process should reflect the appropriate balance between goals and cost.

6. Who's in Charge? At all times in the process, the parties must remember that they are acting at the direction and under the supervision of the board of directors, and it is the board—and not counsel—that will make ultimate decisions on the matter, based on its evaluation of the final report of counsel and any responsive action it may choose to take. The board is expected to exercise informed judgment in this regard. It is not obligated to adopt all of the counsel's conclusions and recommendations automatically, but it rather should consider them on their own merits.

In a more subtle sense, the board should monitor the exercise of judgment and discretion by investigative counsel, assuring itself that counsel is mindful of the consequences that would follow from either overzealous—or underzealous—diligence.

The potential need for an internal, board-directed review of corporate activities, management and/or governance is a fact of life in today's corporate environment—including nonprofits. In evaluating the need for, and potential structure of, such a process, the governing board should follow a deliberate approach designed to satisfy applicable law and serve the organization's best interests.

Michael W. Peregrine, J.D., is a partner in the Chicago office of McDermott Will & Emery, LLP. He can be reached at (312) 984-6933 or through e-mail at mperegrine@mwe.com. **Russell Hayman** is a partner in the Los Angeles office of McDermott Will & Emery. He can be reached at (310) 551-9334 or at rhayman@mwe.com.

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