



Respecting the Line Between Governance and Management

Michael W. Peregrine, Esq., Partner, McDermott Will & Emery, LLP

It may be a thin, grey line that separates governance from management, but it's a line nonetheless. And, in the context of both good governance and the director's personal liability profile, it's a line that should be respected.

Yet, extraordinary times demand extraordinary responses. Non-profit directors are understandably sensitive about how best to satisfy their oversight obligations under the weight of a recessionary economy. Most boardrooms reflect a "roll up our sleeves" attitude—a willingness to make the special efforts necessary to support the organization in difficult times. *We know it's time to step it up.* This attitude is understandably sharpened when the board must confront a significant organizational challenge or systemic breakdown.

Several new external developments also speak to the merits of a more aggressive and involved board. A leading credit rating agency has commented favorably on decisive action by the board (in conjunction with management) to identify looming financial problems and implement immediate corrective action.¹ A recent judicial decision emphasizes the board's obligation to assure payment of federal payroll and related taxes.² Significantly, some well-intentioned governance consultants are recommending direct intervention by the board in day-to-day operations, far beyond traditional board/management boundaries. Proponents of such "micro-governance" concepts argue that the organization is better served in the current environment when the board extends itself beyond its role as policymaker and assumes additional duties of administration and implementation. All of these developments combine to pressure the board to increase the intensity of its oversight obligations.

The question is thus not *whether* boards should be more responsive to the current environment, but *how* they can manifest such responsiveness—without completely assuming the mantle of management. *We get it; we understand; tell us what more we should be doing to help.* It is, in essence, the "responsiveness challenge." Fortunately, non-profit law offers substantial guidance to boards on how to respond to this challenge. The following discussion is intended to provide a multi-level framework from which non-profit directors may evaluate the need to increase the rigor of their oversight duties while still respecting the fundamental separation between governance and management.

Level One: Duty of Care

Any examination of this "responsiveness challenge" must start with a review of the fundamental duty of care. This requires directors to act in good faith, with the same level of care an ordinarily prudent person would exercise *in like circumstances*, and in a manner they reasonably believe to be in the best interests of the corporation. This duty is manifested in two distinct contexts: 1) to a specific decision or particular board action, and 2) to general day-to-day business operations (*i.e.*, oversight of management performance). In exercising the duty of care, directors are expected to establish a "tone at the top" leadership role. This role calls on directors to foster a boardroom culture emphasizing "constructive skepticism" and an active, independent oversight role while maintaining a collegial partnership with management.³ It does not, by itself, direct the board to assume or share specific indicia of management.

Level Two: Core Responsibilities

¹ Moody's Investors Service Special Comment, April 2009.

² *Verret v. U.S.*; 103 AFTR 2d 2009-1189 (2/26/09).

³ American Bar Association, Report of Task Force on Corporate Responsibility, p. 26.

The next step in the analysis is to review the core responsibilities of the board, and how those intersect with the role of management. Fundamental to this is the basic statutory concept that the business of the non-profit corporation is managed under the direction of the board. However, it is recognized that it is not desirable for directors to try to manage the corporation directly and comprehensively.⁴ Accordingly, the board is authorized to delegate day-to-day management responsibilities to qualified executive management. The board must then exercise oversight of executive leadership. Implicit in this delegation is the board's ability to rely on the advice of its leadership team.

Law and "best practice" specify particular duties for the board in its oversight role. Generally speaking, these are centered around the following core principles: 1) selection, compensation, and evaluation of the CEO and related succession planning; 2) overseeing the strategic planning process; 3) comprehension and approval of annual budgets; 4) confirming accuracy/clarity of financial statements; 5) assuring consistency of operations with non-profit mission and tax-exempt status; 6) advising executive leadership on important issues confronting the corporation; 7) rendering informed decisions on major corporate actions; 8) assuring operation of an effective corporate compliance and ethics plan; 9) nominating qualified candidates for board and committee positions and assuring comprehensive director education and self-evaluation protocols; and 10) authorizing the exercise of reserved powers over corporate affiliates as may be established in governing documents or statute.⁵

Again, none of these responsibilities directly involve the board in day-to-day management.

Level Three: Extraordinary Circumstances

In addition to its core responsibilities, the board is obligated to provide enhanced leadership and policy guidance when a crisis or extraordinary controversy confronts the organization. Generally speaking, the required level of care is higher in such circumstances that "special obligations" are imposed upon directors. When called upon to review director conduct in crisis or controversy, regulators and courts will frequently apply close scrutiny to ensure that directors have acted reasonably.

A perfect example of extraordinary circumstances prompting enhanced board leadership is the current economic recession and its effect on the non-profit organization. There seems to be a growing recognition that the non-profit board indeed has "special obligations" in this circumstance, and that they can be satisfied through the following types of pro-active initiatives: 1) increasing the frequency of financial updates from management; 2) greater focus on conflict-of-interest issues relating to the board, management, and advisors; 3) understanding debt covenant ratios and monitoring compliance therewith; 4) increased review of investment policy, continuous monitoring of investment performance, and close evaluation of investment advisors; 5) greater attentiveness to matters of cash reserves, liquidity, and expense management; 6) more aggressive consideration of strategic options through which the non-profit mission can be pursued (e.g., change of control); and 7) in the extreme situation, a willingness to address the benefits and burdens of non-judicial debt restructuring or bankruptcy reorganization.

Each of these initiatives calls upon the board to work more closely with executive management than in the ordinary course of corporate affairs.

Level Four: Red Flags

Another instance in which non-profit directors are called upon to "roll up their sleeves" and become more involved with management is with respect to "red-flag incidents." Most often, these are compliance-related incidents that, once made known to the board, demand an extraordinary governance response.

Like their for-profit counterparts, non-profit directors have four fundamental tasks with respect to red flags: evaluate and respond with requisite process to reasonably available material information; act in accordance with 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 non-profit board must attend to potential red flags that jeopardize the organization's legal profile, respond in a good-faith manner, and take such actions as the circumstances warrant to protect the charitable mission of the organization.

⁴ *Ibid.*

⁵ See, e.g., Business Roundtable, *Principles of Corporate Governance* 2005.

In most compliance-based red flag incidents, the board's action is manifested by the initiation of an internal review or investigation. In such situations, the board is called upon to make the fundamental structural decisions (often in consultation with the general counsel): 1) the scope of the investigation, 2) who or what body should be responsible for managing the investigation on its behalf, 3) the reporting obligations of that party, and 4) the individual(s)/firm actually conducting the investigation.

In red-flag incidents, all involved parties are acting at the direction and under the supervision of the board of directors, and it is the board—and *not executives*—that will make the ultimate decisions on the matter. Thus, red-flag incidents are another example where the board is more involved in management matters than in the ordinary course of corporate affairs.

Level Five: Mandate

Yet another example of where the board is more closely drawn into management affairs is the judicial or statutory mandate. This is a situation in which a law, regulation, or judicial decision specifically mandates the board to assume certain attributes of management. A prominent example of this mandate is the board's obligation to assure payment to the IRS of the organization's employment withholding tax obligations. A recent U.S. Court of Appeals decision upheld an approximately \$408,000 penalty assessed against the board chair of a non-profit hospital for the organization's failure to remit employment withholding taxes.⁶

By the Court's standard, the board's obligation in this respect transcends the basic delegation of budgetary and financial matters to executives. It requires more oversight than periodic inquiry of, or even personal direction to, executive leadership regarding tax payment. Clearly, the Court's expectation is that the board has the ultimate responsibility for satisfaction of payroll tax obligations; that the board must, in effect, "walk the check to the post office."

This new decision is a particularly relevant example of situations where the courts or regulators actually mandate the board to assume a managerial role.

A Note of Caution

Confronting the "responsiveness challenge" is not without risk to the organization, or to the board's liability profile. There is a fundamental difference between the governing board increasing the rigor of its duty of care/oversight obligations, and its assumption of day-to-day management responsibilities. As we have discussed, there are numerous instances in which the law expects—or even mandates increased governance oversight—even to the extent where doing so assumes certain indicia of management. Yet, in *none* of these instances is the board authorized to directly exercise unlimited management authority. To do so is directly contrary to established law and modern governance principles.

As noted above, the modern corporate model assumes that the ultimate obligation for management of corporate affairs rests with the board. While day-to-day responsibility may be delegated to executives, it is nevertheless subject to the board's ultimate direction. So, to a certain extent, the board cannot escape fundamental responsibility for the management of the enterprise.

Even so, this basic corporate precept does not and cannot justify unbridled emersion of the board into day-to-day management matters.⁷ While typically well qualified for an oversight role, individual directors rarely possess the expertise necessary to manage a non-profit corporation in a highly regulated environment. Adding administration and implementation to the board's core policymaking role serves to undermine the system of checks and balances on which the corporate model relies to prevent misuse of authority, unrestrained executive power, and abuse of non-profit assets. Where governance and management duties merge, or substantially overlap, there is no independent board to which executive leadership is accountable. These are issues with which state and federal charity officials are particularly concerned. Furthermore, the effect of such "micro-management" on the crucial protections of the Business Judgment Rule and of directors/officers' liability insurance is uncertain.

What Now?

⁶ Verret, *supra*.

⁷ American Bar Association, *supra*.

Non-profit directors are expected to respond to the current recessionary environment with increased oversight across a wide range of corporate affairs. In many instances, the necessary extent of enhanced oversight requires board members to assume certain limited indicia of management. In no instance, however, is the board obligated, expected, or obliged to fully assume or share with executive leadership day-to-day management responsibilities. Earnest attempts by the board to satisfy the “responsiveness challenge” must be tempered by the critical need to retain a strong system of checks and balances. The line separating governance from management may be thin, and gray, but it is a line nevertheless, and must be respected for the best interests of the corporation and its individual directors.

The Governance Institute thanks Michael W. Peregrine, Esq., partner, McDermott Will & Emery, LLP, for contributing this article. He can be reached at mperegrine@mwe.com.