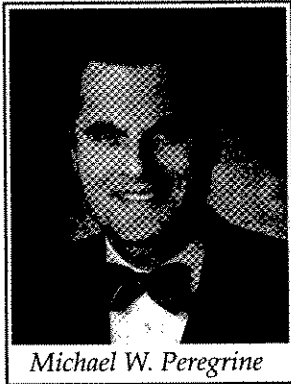


## The Continuing Evolution of Nonprofit Governance Best Practices

by Michael W. Peregrine



Michael W. Peregrine

Michael W. Peregrine is a partner at McDermott Will & Emery LLP, Chicago.



The recently released *Principles of Good Governance and Ethical Practice: A Guide for Charities and Foundations* by the Panel on the Nonprofit Sector represents a significant contribution to corporate governance discourse.<sup>1</sup> The 33 “principles of sound practice,” as the

panel report describes them, are offered for consideration by every nonprofit charitable corporation as a reference for their efforts to strengthen governance effectiveness and accountability. Many of the recommended principles address governance themes and concepts beyond those that evolved after the Sarbanes-Oxley Act of 2002; they are truly second generation in nature. Further, the recommendations emerge during a period of unprecedented legislative, regulatory, and media scrutiny of the governance practices of tax-exempt, nonprofit corporations. As such, the recommendations reflect the organic nature of corporate governance as well as the need for nonprofit boards to continuously monitor developments in the area and to make refinements to existing policies as those developments may warrant. For these and other reasons, the panel report represents must-reading for nonprofit boards, their governance committees, and legal counsel. (For the panel’s report see *Doc 2007-23362* or *2007 TNT 203-29*.)

This paper will review the panel report in the context of the current regulatory environment and the prophylactic value of best practices, and will offer suggestions on the proper response by nonprofit boards.

<sup>1</sup>Available at [http://www.nonprofitpanel.com/selfreg/Principles\\_Guide.pdf](http://www.nonprofitpanel.com/selfreg/Principles_Guide.pdf). (Released Oct. 18, 2007). Henceforth referred to herein as panel report. Except where otherwise noted to the contrary, quotations and other textual references to the recommended governance principles are taken directly from the panel report.

### I. Goals, Objectives, and Organization

The panel report’s recommended principles are grounded in the basic tenet that nonprofit organizations must maintain the public trust if they are to reach their charitable goals. The principles reflect an awareness of the harm that can arise from the rare instances of improper or unethical conduct by individual nonprofits and from excessive regulatory/legislative responses to misconduct. In that regard, the panel report says it seeks to strike a balance between (a) “prudent legal mandates” designed to assure that nonprofits do not abuse their special legal/tax status; and (b) “well-informed self governance.” This balance, the panel report says, is “crucial” to preserving organizational flexibility and to assuring effective internal structures of accountability and transparency. While acknowledging that many nonprofits already have adopted basic standards of governance and ethical practice, the panel report seeks to establish a “comprehensive set” of guidelines that can apply to the entire nonprofit sector. For that reason, and because of the credibility of the panel itself, it is reasonable to assume that the recommended principles may evolve into de facto best practices for the nonprofit sector. Some state charity officials have already begun referring to the principles in that context.<sup>2</sup>

The 33 recommended principles break down into two categories — firm rules and more flexible principles — the distinctions between which are “essential to understanding and using this document,” the panel report says. The first six principles are those that the panel believes nonprofit organizations are obligated to adopt, as a matter of law. The remaining 27 principles are those that nonprofits should strongly consider adopting, “based on their legal and operational structure and their particular charitable purposes,” according to the panel report.

The 33 principles are organized into four general categories:

1. *Legal Compliance and Public Disclosure*: recommendations (for example, conflict-of-interest and

<sup>2</sup>California Attorney General Bill Lockyer, “Report on the Office of the Attorney General’s Investigation of the J. Paul Getty Trust,” Oct. 2, 2006; [http://ag.ca.gov/newsalerts/cms06/06-085\\_0a.pdf](http://ag.ca.gov/newsalerts/cms06/06-085_0a.pdf).

whistle-blower policies) designed to help nonprofits comply with their legal obligations and to provide information to the public.

2. *Effective Governance*: recommendations designed to help a board fulfill its oversight and governance obligations.

3. *Strong Financial Oversight*: recommendations designed to assist a board as it exercises stewardship of charitable resources.

4. *Responsible Fundraising*: recommendations designed to guide the manner in which nonprofits solicit funds from the public.

The panel report is not intended to create a universal set of standards to be adopted by every nonprofit corporation. Rather, the panel report says its principles are intended as a "guidepost" for the adoption of practices that best fit the size and charitable purpose of an individual organization. It is expected that a nonprofit's board would closely review all 33 of the principles and determine how the organization might apply each to its own operations (again, lending support to the de facto best practices application). The panel expects that based on that review, the board may conclude that some of the recommendations either do not apply or have already been satisfactorily addressed by existing board policy. Other recommendations may, however, fill a void in the organization's governance protocols. Regardless of the result, a transparent process of evaluating the organizational applicability of the principles provides an intrinsic governance benefit and favorably reflects on the board's good faith and commitment.

## II. Background: The Environment

The October 2007 publication date of the principles is fortuitous when one considers the enormous focus during the past year on governance practices of nonprofit corporations. For example, in 2007 the IRS has manifested its new focus on governance in multiple ways (such as public comments by officials, proposed questions on the revised Form 990, proposed governance guidelines of healthcare organizations). Indeed, in a series of speeches this year, IRS Commissioner Steven Miller has spoken forcefully on the IRS's focus on corporate governance of exempt organizations. Mr. Miller has repeatedly referred to governance as a new "pillar" of the IRS's education and enforcement program for tax-exempt organizations.

Leading charities such as the American Red Cross and the Smithsonian Institution have implemented substantial revisions to their governance structures and policies in response to highly publicized internal controversies. Judicial decisions have focused greater attention on governance structures and exercise of fiduciary obligations. Congress (particularly the Senate Finance Committee) continues to consider an enhanced role for the federal government in the oversight of charity governance. The media have been saturating the public with stories alleging abuse by nonprofit boards of their fiduciary obligations.

## III. What's New and Distinctive

Vital to any board's consideration of the panel report is that through the introduction of many new and distinctive recommendations, they materially elevate the discussion of nonprofit governance practices. The individual principles are far more than a re-hash of the generally recognized Sarbanes-Oxley governance themes: audit committee oversight, financial integrity, and financial transparency. The principles, some of which are reprinted below, are different because they introduce multiple new concepts not previously considered to be in the governance mainstream. The new concepts include the following:

**Conflicts of Interest (Principle #3):** "A charitable organization should adopt and implement policies and procedures to ensure that all conflicts of interest, or the appearance thereof, within the organization and the board are appropriately managed through disclosure, recusal, or other means." The review and management of conflicts of interest remain a lightning rod for regulatory and media attention. This principle serves a useful purpose by reminding boards that conflict resolution may, by nature, be flexible; in other words, while some conflict-of-interest transactions may be illegal, unethical, or inappropriate, others may be capable of being approved, as in the best interests of the organization (as long as clear procedures are followed). The keys to an effective process are timely and complete disclosure of potential conflicts and a transparent review process in which board members are able to understand the nature of the conflict and whether it can be appropriately managed.

**Risk Management (Principle #6):** "A charitable organization's board should ensure that the organization has adequate plans to protect its assets." This principle indirectly endorses the concept of enterprise risk management as a proper topic for formal board attention. It concludes that boards are responsible for understanding the major risks to which the organization is exposed, reviewing those risks periodically, and ensuring that systems are in place to manage those risks effectively. Many nonprofit organizations have long maintained components of such a strategy (for example, corporate compliance plans, insurance covering key assets, technology backup, asset insurance, and indemnification and insurance protection for officers and directors). With this principle, however, the panel describes additional components of enterprise risk management and encourages boards to evaluate risk mechanisms from a more global perspective. This is particularly important given increasing, unfortunate instances of embezzlement and financial impropriety within nonprofit organizations.

**Transparency (Principle #7):** "A charitable organization should make information about its operations, including its governance, finances, programs, and activities, widely available to the public." This principle stresses the importance of organizational and operational transparency and encourages its practice to a level perhaps beyond that which many nonprofits have previously occupied. Suggested elements of transparency include Web site access to the organization's annual report, the annual Form 990, financial statements, vision and mission statements, lists of board and staff members, statements of values and codes of ethics, and policies on

conflicts of interest, whistle-blower protection, and travel expense reimbursement. Such a degree of transparency would likely be favorably viewed by state and federal charity regulators.

**Board Constituency (Principle #11):** "The board of a charitable organization should include members with the diverse background (including, but not limited to, ethnic, racial, and gender perspectives), experience, and organizational and financial skills necessary to advance the organization's mission." This principle expands the focus on desired board diversity beyond traditional concepts of community leadership, business and financial acumen, and experience (specific to the particular industry) to include concepts of ethnicity, race, and gender. This new emphasis on cultural diversity in the boardroom is consistent with the requirements for board composition in the controversial draft proposal on hospital tax exemption standards submitted by staff to the Senate Finance Committee earlier this year.

**Director Independence (Principle #12):** "A substantial majority of the board of a public charity, usually meaning at least two-thirds of the members, should be independent." This principle will increase the focus on director independence as a governance issue separate and distinct from conflicts of interest. It also emphasizes the need to reconcile separate and potentially inconsistent concepts of board/committee member independence under provisions of corporate/governance law and practice and federal tax law (for example, the community benefit standard for hospital tax-exempt status mandates that the board be controlled by community leaders). From a broader perspective, this principle likely will be controversial, as many nonprofits can be expected to struggle to implement a two-thirds standard of independence. The principle will also increase the policy debate on the definition of independence as it applies to the nonprofit director and the importance of maintaining board and key committee control in independent directors.

**Executive Compensation (Principle #13):** "The board should hire, oversee and annually evaluate the performance of the chief executive officer of the organization." This principle reinforces several aspects of sound practice regarding board determination of reasonable executive compensation: (a) regardless of the role and efforts of the compensation committee, the full board should be required to review the performance and approve the compensation of the CEO annually in advance of any change in compensation; (b) the compensation committee should consist of independent members; (c) the compensation consultant engaged by the board should be similarly independent; (d) it is acceptable to consider data from comparable tax-exempt and taxable corporations in determining reasonable executive compensation; and (e) the board/compensation committee should also review the overall compensation program of the organization.

**Director Evaluation (Principle #16):** "Board members should evaluate their performance as a group and as individuals no less frequently than every three years, and should have clear procedures for removing board members who are unable to fulfill their responsibilities." This principle will likely prompt boards to (a) consider more closely the detail and effectiveness of self-evaluative practices and procedures; (b) adopt more detailed guide-

lines on the duties and obligations of each member; and (c) expand the director removal process, including consideration of related provisions, such as enhanced obligatory disclosure and automatic resignation upon the occurrence of events that call into question the integrity or the continued fitness to serve of individual directors. Thus, this principle may be used by the board to resolve existing and expected difficult political issues involving individual directors.

**Obedience to Mission (Principle #19):** "The board should establish and review regularly the organization's mission and goals and should evaluate, no less frequently than every five years, the organization's programs, goals and activities to be sure they advance its mission and make prudent use of its resources." This principle speaks to the basic, but often underappreciated, fiduciary concept of duty of obedience to corporate mission; in other words, the obligation of the board to assure that its decisions are consistent with, and in support of, the charitable mission of the organization. This is an important concept in the nonprofit sector, given (a) the repeated comments by senior IRS officials concerning a blurring of the line between the tax-exempt and commercial sectors (particularly in healthcare); and (b) the current policy debate on charity care and community benefit, at both the federal and state levels.

**Board Compensation (Principle #20):** "Board members are generally expected to serve without compensation, other than reimbursement for expenses incurred to fulfill their board responsibilities." Even though this principle was softened through the drafting process, it nevertheless reflects a basic bias against compensation of nonprofit directors. The principle is likely to be controversial, because the nonprofit laws of many states either directly authorize, or at least are silent on, the payment of reasonable compensation to directors. Even so, the principle is supportive in that it speaks to the standards that can be used to support compensation of board members when provided: appropriate comparability data, documentation of underlying decision, and full disclosure of the amount of and rationale for the compensation to any interested party.

**Investment Oversight (Principle #22):** "The board of a charitable organization must institute policies and procedures to ensure that the organization (and, if applicable, its subsidiaries) manages and invests its funds responsibly, in accordance with all legal requirements." This principle is a useful reminder to the board regarding the importance of its stewardship role regarding the management of investments. This is particularly true with volatile financial markets, the availability of high-risk/high-reward investment vehicles, and the emergence of new uniform laws governing the prudent investment of institutional funds held by charitable organizations. The principle is timely, given the expression of concern by at least one health industry rating agency with the level of board oversight of investment management.<sup>3</sup>

<sup>3</sup>Moody's Investors Service/Moody's U.S. Public Finance-Special Comment, Nov. 2007, "Not-For-Profit Hospitals Vulnerable to Investment Market Volatility." Analyst contacts: Lisa (Footnote continued on next page.)

**Spousal Travel (Principle #26):** "A charitable organization should neither pay for nor reimburse travel expenditures for spouses, dependents or others who are accompanying someone conducting business for the organization unless they, too, are conducting such business." This principle will be viewed favorably by many compensation committees, general counsel, and compliance officers called on to address politically sensitive issues regarding travel expense reimbursement. This principle essentially puts another nail in the coffin of the increasingly discredited practice of reimbursement of spousal expenses, particularly given the difficulty in identifying a legitimate business purpose for most types of spousal travel.

**Charitable Solicitation (Principles #27-33):** These are a series of what the panel calls "responsible fundraising" principles, which emphasize important issues such as (a) charitable solicitation and donor communications; (b) assurance that contributions will be used consistent with donor request; (c) providing donors with acknowledgements of charitable contributions; (d) the adoption of policies governing the basis for rejecting proposed donations on ethical, financial, program focus, or other grounds; (e) provision of appropriate training for, and supervision of, organizational staff involved in charitable solicitation/management of institutional funds; (f) appropriate compensation method for fundraisers (external or internal); and (g) controls regarding donor privacy. These are all issues that have been the subject — both individually and collectively — of substantial legal controversy within the nonprofit sector in recent years, yet historically have not been included within best practices compilations. Many nonprofit boards are unlikely to have adopted those controls but should consider doing so if they are involved in charitable solicitation activities to any significant degree.

#### IV. What's Missing

The panel report notes that strengthening ethics and accountability in the nonprofit sector is a process of continuing vigilance and adaptation. The report clearly acknowledges the likely future need to refine the core set of 33 recommendations; in other words, the 2007 version of the principles should not be considered a static document.

Indeed, recent events in the nonprofit sector strongly suggest at least one important addition to the recommendations presented in the principles' Effective Governance category. Arguably, a new best practice is emerging that calls on nonprofit boards to assure adequate legal controls in general and to mandate access of the general counsel to the board (including attendance at all meetings) in particular. Developments such as the December 2006 report of the New York City Bar Association (on the

role of the lawyer in corporate governance)<sup>4</sup> and the World Bank and Smithsonian controversies demonstrate the wisdom of increasing the organizational profile of the general counsel and of the risks associated with efforts to minimize that role. Indeed, new governance policies adopted by the Smithsonian on this point are justifiably considered trailblazing and are likely to be copied by other organizations.<sup>5</sup>

#### V. The Role of Best Practices: Conclusion

In considering the panel report, it is important to note the significant distinction between best practices as a goal and fiduciary duty as a legal obligation. Leading judicial decisions have noted that while governance best practices include compliance with fiduciary duties, that compliance may not always be enough to satisfy governance best practices. In other words, failure to comply with best practices does not, in and of itself, constitute a violation of fiduciary duty.<sup>6</sup>

Nevertheless, courts and regulators often encourage directors and officers to employ best practices. More pointedly, an influential former chief justice of the Delaware Supreme Court has commented that the thoughtful and attentive pursuit of governance best practices can be a demonstration of good faith:

The movement in corporate America to achieve best practices is key. Good corporate practices, when genuinely used [,] . . . would perforce and simultaneously lead directors to act in good faith. . . . The conscientious pursuit by directors of principles of best practices is the best prophylactic against liability.<sup>7</sup>

Thus, perhaps it can be said that for reasons of good faith alone, the prudent course for the nonprofit board is to review the *Principles of Good Governance*, take note of provisions that address issues not covered by the board's existing governance policies and procedures, and make related changes when doing so is in the best interests of the charitable mission. This is particularly important as the IRS and state charity officials increase their oversight of corporate governance and as the principles evolve to standard-of-conduct status.



**Author's Note:** Portions of the above discussion are based on portions of articles the author has previously published through the American Health Lawyers Association (Corporate Governance Task Force), Stuart I. Silverman, task force chair.

<sup>4</sup>[http://www.nycbar.org/pdf/report/CORPORATE\\_GOV\\_ERNANCE06.pdf](http://www.nycbar.org/pdf/report/CORPORATE_GOV_ERNANCE06.pdf).

<sup>5</sup>See, e.g., Michael W. Peregrine, "Smithsonian Controversy Spawns 'Second Generation' Best Practices," *The Exempt Organization Tax Review*, Sept. 2007, p. 277.

<sup>6</sup>*In re Walt Disney Derivative Litigation*, Case No. 411, 2005 (Del. June 8, 2006).

<sup>7</sup>E. Norman Veasey, "Counseling Directors in the New Corporate Culture," *The Business Lawyer*, Vol. 59, Aug. 2004 at 1456-1457.

Martin, senior vice president; Lisa Goldstein, senior vice president; Roger Goodman, vice president-senior analyst; John Nelson, team managing director ((212) 553-1423).