

EO Director Recruitment and Retention in a Post-Sarbanes World

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It's becoming a seller's market. The recruitment and retention of qualified directors will be one of the most significant governance challenges for the nonprofit corporation in the post-Sarbanes/Oxley world. The ability and willingness of the volunteer director to serve¹ is increasingly being tempered by concerns such as personal liability exposure, increased workload,² and appropriate limitations on charity board membership. Given these understandable concerns, nonprofit organizations must be pro-active in order to attract competent director candidates, and to convince experienced directors to continue their service. Make no mistake about it — these individuals *will* have board service choices. Fortunately, the law offers a variety of means available to nonprofit corporations in their governing board recruitment and retention efforts.

The Roots of the Challenge

This isn't about the *Sarbanes-Oxley* Act itself — we're way beyond that. Rather, the director recruitment/retention challenge is tied to the broader corporate responsibility environment arising in the wake of the Act. This environment calls on governing boards to be more focused not only on matters of financial integrity and transparency — the hallmarks of *Sarbanes* — but also on enhanced exercise of general oversight responsibilities. To be sure, the core fiduciary duties of care, loyalty, and obedience have not changed. What *has* changed, though, is the screen through which the performance of these duties will be evaluated; i.e., a sharper focus is being applied by courts and regulatory agencies to director conduct. Indeed, breach of duty actions against nonprofit directors have increased in the last several years, and will likely continue to increase as regulatory agencies, dissident directors and



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members, and substantial donors exhibit an increasing willingness to challenge board decisions, particularly in the areas of executive compensation, related party transactions, sales of substantial assets, and the closure or geographic relocation of programs or facilities that are viewed as community assets.

For example, recent opinions from the prominent Delaware courts demonstrate a judicial willingness to hold corporate directors more accountable for their oversight conduct and to limit the deference historically provided under the business judgment rule. Indeed, in two separate, recent instances, directors agreed to contribute substantial amounts of personal assets as part of a settlement of securities and pension fraud shareholder class action litigation related to the financial collapse of the organization on whose board they served.³ Allegations regarding director misconduct are now making regular appearances in the financial media. Furthermore, there is a general recognition that the job of the nonprofit director has become more time-consuming. Statutory and regulatory attention has been placed on such matters as director qualifications and independence, financial literacy, level of preparedness, time spent on board matters, and extent of

¹A 2002 survey conducted by the Booz Allen consulting firm found a 23 percent vacancy rate on nonprofit boards (Julie Connelly, "Next off the Griddle: Nonprofit Boards," *Corporate Board Member*, Nov/Dec 2003)

²Surveys of public company directors have demonstrated an increase in time commitments of 25-50 percent in the face of *Sarbanes-Oxley* and the new corporate responsibility environment (*Seattle Times*, Oct. 3, 2004).

³*In re Enron Corp. Securities Litigation*, Texas No. H-01-3624, 1/7/05 (see also, BNA's *Corporate Accountability Reporter*, Vol. 3, No. 2 (p. 30), January 14, 2005; *In re WorldCom Inc. Securities Litigation*, S.D.N.Y., No. 02-CIV-3288, 2/2/05; BNA's *Corporate Accountability Reporter*, Vol. 3, No. 5 (p. 108), February 4, 2005).

outside board service. Directors are also now being asked to exercise “constructive skepticism” with respect to board matters, a standard that places them at greater risk of conflict with corporate executives.

All of this has made directors/officers’ liability insurers more attentive to levels of (and exceptions to) their coverage. Indeed, some creative plaintiffs in fiduciary duty cases are framing their allegations in the context of “bad faith” and “breach of duty of loyalty” claims, which typically are not covered by director insurance policies and which may create indemnification issues under state laws.

The Candidate’s Concern

Given all that, an otherwise qualified director candidate will be much more circumspect in selecting board service opportunities in this environment. The informed director candidate is more likely to limit volunteer service so as not to over-commit (and thus, underperform). This candidate may conduct personal due diligence with respect to the business and legal/ liability profile of the corporation. Specific inquiry may be placed on whether the nonprofit board has embraced the spirit of corporate responsibility. An obvious concern will be the level of available insurance and indemnity protection. A less obvious but nevertheless important concern will be the *quality* of the board and its governance policies/practices. In these and other ways, the director candidate in the corporate responsibility environment will be much more informed — and thus, a much harder “sell” — with respect to the realities (as well as the benefits) of nonprofit board service.

Large numbers of board members of major nonprofit organizations also serve on boards of public companies. In this regard, they have become accustomed to seeing fully independent audit committees that serve as a first line of defense in matters involving financial issues, knowledgeable and sophisticated compensation committees (using independent compensation consultants when appropriate) to deal with issues of executive and board compensation, and contractual indemnification guarantees (where permitted by statute) to provide maximum protection and minimize personal financial exposure. As such, they can be expected to demand no less from any nonprofit organization that seeks their time and energy as board members.

Meeting the Challenge

The corporate responsibility challenges of director recruitment/retention should not be daunting to the attentive, organized, and responsive nonprofit governing board. Simply recognizing that the challenge exists and must be met with some commitment of board resources is a major step toward meeting that challenge. As noted above, nonprofit corporate law provides a wide variety of mechanisms that can be used to reduce director anxiety and significantly enhance recruitment and retention efforts. Moreover, those nonprofit organizations that recognize the changing regulatory and legal environment and take affirmative

steps to improve their corporate governance structures and to protect their board members in the exercise of the decisionmaking process may find themselves at a competitive advantage in recruiting and retaining high quality boards of directors. This article proposes a six-point approach by which the sophisticated nonprofit governing board may pursue a director recruitment/retention initiative. The plan reflects a perspective that the effective recruitment/retention plan must combine a series of factors, including: (a) familiarity with recruitment needs; (b) attentiveness to the nonprofit’s corporate responsibility profile; (c) responsiveness to liability exposure issues; (d) steps to improve the overall quality/fitness of the board; and (e) adoption of other measures designed to make board service more attractive.

Point One: Knowing Your Needs

An important first step in the development of any effective recruitment/retention program is to assign responsibility for that program to a specific committee (e.g., Governance, Nominating, Volunteer Development) and request that the committee identify specific recruitment needs of the board. In other words, it is incumbent on the board/relevant committee to have a clear vision of the board member needs (e.g., qualifications, age, diversity) before it proceeds with a recruitment or retention initiative.

Many progressive nonprofit governing boards/committees effect this process through the preparation of a matrix or similar mechanism that compares the board’s pre-established membership criteria (see Point Three, below) against its existing membership. The expectation is that by applying the matrix, the needs of the board concerning new members with valued qualifications and backgrounds can be better identified; i.e., the “holes in board membership” are more readily exposed. With this information in hand, the committee is more capable of conducting recruitment and succession planning activities in a manner consistent with its own pre-established needs. The director self-evaluation process (see below) can similarly be helpful in the self-identification of needed board member competencies.

These processes will be helpful in avoiding the trap of pursuing recruitment activities solely through the universe of pre-existing social and/or professional acquaintances of the existing board members. Further, the use of professional search firms to supplement board efforts is becoming an increasingly favored tool by which larger organizations recruit qualified directors for their governing boards.

Point Two: The Corporate Responsibility Profile

An effective director recruitment/retention plan must be responsive to the director candidate’s interest in conducting due diligence on the organization and its corporate responsibility profile. The attentive candidate will certainly be interested in the fundamentals regarding the organization, e.g., its mission, its organizational structure, and its financial and regulatory

condition. More importantly, the candidate will be interested in the organizational response to the corporate responsibility environment. Has the board adopted new membership criteria? Is it preserving board control in a majority of “independent” directors? Has it revamped its governance oversight of financial matters and of the audit process? Is the board more attentive to the corporate compliance plan? What “best practices” have been adopted?

The board must be poised to provide the director candidate with a succinct but comprehensive presentation of the organization’s corporate responsibility profile. The goal of this profile is to provide assurances to the candidate that the organization has adopted a prudent response to the most pressing governance problems of the day.

Point Three: Addressing Liability Exposure

A critical aspect of any recruitment/retention plan is the ability to demonstrate the governing board’s commitment to reducing the candidate’s liability exposure. This can involve several important measures.

The most obvious of these measures is to provide assurances of the sufficiency of available liability protections. This could involve (a) confirmation that the corporation offers the maximum amount of director indemnification provided by state law; (b) making available to the candidate the terms and conditions of the organization’s existing directors’ and officers liability insurance coverage; (c) demonstrating how the organization protects directors against identified gaps in coverage (e.g., “wasting” policy, coverage exceptions, presence of a duty to defend clause); (d) providing contractual indemnification protection where permitted by state law; and (e) providing assurances regarding policy renewal.

Other effective measures include several that are designed to enhance the director’s ability to make an informed decision and (where applicable) preserve application of the business judgment rule. This would include a confirmation of the sufficiency of the board’s decision-making process (e.g., that information is provided in a timely manner, meeting standards are enforced, directors are required to be fully engaged, regular access to senior management and to outside advisors clearly provided, appropriate use of outside independent professionals in higher-risk decision-making areas). It also would include the adoption of a comprehensive conflicts of interest policy designed to materially reduce the potential that director self-interest may void a transaction and create related liability to the board. In addition, the board’s role in oversight of the corporate compliance plan would be emphasized. Also persuasive could be evidence of the extent to which decisions of the governing board are designed to be consistent with the charitable purposes of the organization.

Point Four: Assuring Board Quality

With apologies to Groucho Marx, a director candidate is more likely to join a board where the candidate

is impressed with the qualifications of the existing board members. In other words, the quality and competence of individual directors — and the governing board’s efforts to preserve and enhance that level of quality and competence — can be highly persuasive to the candidate.

There are a variety of measures that a governing board may implement that could be influential to a director candidate concerned with board quality issues. First in this regard is likely to be the adoption of a code of ethics/corporate conduct, which would apply to all organizational constituents (including but not limited to directors). Second could be the establishment of a formal, written set of criteria for the selection of officer and director candidates, as a guide for the nominating committee. Use of such criteria can be of significant assistance in achieving appropriate levels of qualifications and diversity in board membership. Closely associated would be the performance of some fundamental level of due diligence — above and beyond the traditional questionnaire — into the background of candidates. Also relevant would be the adoption of guidelines establishing the basic expectations of a board/committee member (e.g., as to attendance, preparation, time commitment, loyalty). Materially enhanced new director orientation focusing more closely on the institution, its organizational structure, and business model would be an attractive feature. Similarly appropriate would be a more intensive process of director education, with greater focus on developments affecting the organization’s business model, applicable laws and regulations, and director standards of conduct. Becoming more useful in the current environment are mechanisms that allow for discreet means of dealing with a director who has encountered a material personal or business issue affecting his/her continued ability to serve. Similarly, term limits serve to assure continued board access to fresh views while rotating off the board directors whose views/vitality may have become stale or insular.

Other types of governance policies are designed to improve the attentiveness, loyalty, and business judgment of directors. These types of policies cover issues such as directors serving as corporate vendors, limitations on service on other boards, formal director “independence” requirements, and regular executive session practice (both independent director only, and with the general counsel).

Point Five — The Gradual Approach

Some director candidates are generally interested in service but are reluctant — or circumspect — about assuming the duties of voting board membership. To retain the commitment and contribution of such potentially valuable volunteers, the prudent nonprofit governing board will offer an array of hopefully attractive options to full board membership. These options include committee membership, service as an advisory board member, and membership in a related institutional support organization. Each of these options can serve as a basis from which the individual can learn

about the organization, be more comfortable with the expectations of board membership, and be assured concerning related personal liability protection. Collectively, this gradual approach may be an effective way to develop institutional loyalty and future board service from an initially reluctant candidate.

Point Six — Compensation

No director recruitment/retention plan can truly be considered complete without at least having considered the compensation alternative. Traditionally frowned on as unnecessary or as an affront to the mission-oriented director, compensation options are rapidly gaining in acceptance in the post-Sarbanes environment. This can be attributed to a number of factors, including but not limited to the increased workload of the nonprofit director, the widespread use of director compensation in the for-profit world, and increased questions on the ability of the board to compensate directors for spousal expenses related to board service.

The problem, thus, is not simply *whether* a nonprofit can institute such a plan, but *how it goes about implementing* such a plan. There are a number of significant legal issues that must be recognized and addressed by the board before it implements a director compensation plan. These issues include core legal feasibility under state law, selecting the most legally appropriate compensation vehicle, dealing with conflicts of interest in adopting the actual plan, satisfying the private inurement and intermediate sanctions tax rules, addressing special rules applicable to physician-directors, considering the related income tax implications for individual directors, and evaluating the impact of

such a plan on statutory director liability shields. If these issues are properly addressed, the board should be able to effect its plan with comfort and confidence. If they are ignored or otherwise addressed improperly, the board may find that its plan will boomerang and create additional liability for the corporation and the individual directors.

Wrapping It Up

Indeed, it has become a seller's market. The corporate responsibility environment has radically affected the concept of board service not only in terms of liability exposure but also at the more pragmatic level of commitment and effort. In response, some qualified director candidates are simply withdrawing completely from voluntary board service, while others are dramatically limiting the extent of their commitment of service. They can pick and choose from a variety of nonprofit service opportunities. At the same time, the need for active, vigorous, independent board oversight of corporate affairs has never been greater.

Faced with such a challenge, the sophisticated and attentive nonprofit corporation will respond with a comprehensive plan designed to recruit qualified new directors, and retain in service existing directors who provide valuable service. Such a plan may seek to attract the director candidate through use of a variety of mechanisms including focusing on such important matters as the comprehensive nature of the board governance policies, the board's commitment to both *Sarbanes* reform and to qualified board members, maximum available liability protection mechanisms, alternatives to board service, and (in certain circumstances) compensation.