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# *Nonprofit Board Best Practices*

2007 NATIONAL DIRECTORS INSTITUTE

# NONPROFIT BOARD BEST PRACTICES

In the wake of the Sarbanes-Oxley Act (SOX) and the generally increased scrutiny of corporate governance in recent years, board members and executives in the nonprofit sector have asked themselves what best practices they should employ in their own sector. While SOX generally applies only to publicly traded companies, many of its principles may be applied to non-publicly-traded organizations, including many nonprofit corporations.

Richard Riley, partner, Foley & Lardner LLP, and Stephen Cruise, managing director, UBS Securities LLC, co-moderated “Non-Profit Board Best Practices,” a featured session at Foley’s sixth annual National Directors Institute on March 7, 2008 in Chicago, to discuss these issues. Other panelists included Janet Knupp, president, The Chicago Public Education Fund; Daniel Hale, executive vice president, Trinity Health; Michael Tiknis, managing director, Harris Theater for Music and Dance; and David Rowan, chief legal officer, Cleveland Clinic Foundation.

## Introduction

On the Internal Revenue Service (IRS) Web site, a publication entitled “Good Governance Practices for 501(c)(3) Organizations” provides the following good governance or best practices:

- Adopting a ***mission statement*** to "explain and popularize" the organization's purpose and to guide its work
- Adopting, using and regularly evaluating a ***code of ethics*** and a ***whistleblower policy***
- Exercising ***due diligence*** consistent with the duty of care and ensure that policies and procedures are in place such that directors have the information necessary to make informed decisions
- Owing the organization a ***duty of loyalty***, which requires that directors act in the interest of the organization and avoid conflicts of interest that are detrimental to the organization pursuant to a ***conflict of interest policy***
- Promoting ***transparency*** in all activities by adopting and monitoring procedures designed to ensure that organization's Form 990, annual reports, and financial statements are complete and accurate, are posted on the organization's Web site, and are made available to the public upon request
- Adopting and monitoring a ***fundraising policy*** to ensure that fundraising solicitations meet federal and state law requirements, solicitation materials are accurate, truthful, and candid, fundraising costs are reasonable, and registered fundraisers are utilized and monitored
- Operating in accordance with ***financial and auditing protocols*** based on the size of the organization's assets. (Such protocols might include the use of an audit or finance committee, additional internal review by the board of financial and audit-related materials, and independent and, in some cases, rotating auditors)

- Following ***reasonable compensation*** practices, including potential use of the rebuttable presumption method of Internal Revenue Code Section 4958 when deciding on compensation for officers and staff, and generally not compensating directors except reimbursement for direct expenses
- Adopting a ***document retention policy*** that establishes standards for document integrity, retention, and destruction, including guidelines for handling electronic files, and providing procedures for the archiving of documents and regular check-ups regarding the reliability of the document retention system

These practices are important because the IRS is the primary regulator of the nonprofit world.

**Nonprofit Governance Considerations**

Nonprofit organizations should put certain mechanisms in place through which each board member is involved in evaluating the company's president or chief executive officer. In particular, each board member should evaluate the president or CEO based on both quarterly and annual goals that are clearly specified in advance. At every board meeting, board members should then verify whether the president or CEO is performing the way he or she should in order to accomplish pre-set goals. Moreover, nonprofit boards should return to strategic planning at regular intervals.

The board also should provide periodic strategic evaluations of itself, assessing whether the organization should continue to exist, or whether it makes sense to dissolve or to merge with another entity. This periodic strategic evaluation is important because market conditions do not exist in the nonprofit sector as they do in the for-profit sector to make non-performing or underperforming nonprofits go out of business.

Regarding conflict of interest policies, each nonprofit organization should not only adopt a conflict of interest policy, but it also should adopt a value statement, which can be an effective way to deal with potential conflicts.

Finally, organizations should create formal board development and governance committees. Such committees should not be composed of directors who are friends with the president or CEO because the personal relationship may be an impediment to pushing the president or CEO to achieve goals.

**Deciding Whether to Join a Nonprofit Board**

Prior to accepting an invitation to serve on a nonprofit board:

- Find out what kind of indemnity provision the organization has
- Ask whether any taxes are in arrears
- Review the organization's conflict of interest policy
- Review the directors and officers liability (D&O) insurance policy

Such steps are important because prospective board members must be realistic about the risks of being involved with the organization. Generally, the risks of becoming involved with a grant-making entity such as a typical private foundation are quite low, whereas the risks for a health care entity are larger and the risks of becoming involved with, for example, a drug and alcohol abuse halfway house may be quite significant. A prospective board member of that type of organization needs to be more attentive to the organization's D&O insurance coverage.

The process of recruiting nonprofit board members is essentially a sales process and usually, only the positive aspects of becoming a member of that board will be highlighted. A prospective member should ask hard questions prior to joining a board, and in particular, ask how much fundraising they will be asked to do and what kind of time commitments they will be asked to make. Such questions are important because a positive relationship between members of a board and the organization they serve begins with having the board members understand their responsibilities.

**Board Operations**

To keep board operations running smoothly, agendas should be set prior to every board meeting, structure and process should be ingrained into all board operations, the chairperson should actively handle matters on a regular basis, and committees should have strong chairs — particularly the audit committee.

**The Importance of Independence**

Prospective board members should be evaluated and recommendations should be made as to whether that prospective board member can reasonably be considered independent. In doing so, first determine whether any inter-relationships exist between the organization and the prospective board member's businesses. Then look to other relationships, such as family relationships, to see if the individual is indeed independent.

Companies often struggle with the decision whether the board chair, who ultimately is responsible for oversight and governance, should be independent. While independence from the president or CEO of the organization is important, it is also critical that board chairs not be removed or remote from the organization that they are leading.

Succession planning can be a good way to ensure continued independence, promote transparency, and ensure that the president or CEO is exposed to different leadership and organizational approaches. Such succession planning for the board chair should also be accompanied by putting individuals in positions such as vice chairman so that they may learn and train to be the potential subsequent chairman.

**Divided Boards — The Problematic Nature of Separate Fundraising and Operational Responsibilities for Board Members**

Some organizations split a nonprofit's board such that some board members have fundraising responsibilities and others have operational responsibilities. This practice can be problematic.

If a company has board members who are only interested in fundraising, it can indicate the need for education of board members regarding their legal and fiduciary responsibilities. Sometimes an organization will put an endowment in a separate legal entity to protect the endowment from potential liability. However, that practice would be motivated by director liability and the conclusion that it makes affirmative sense to create a separate legal entity to do fundraising rather than an ultimate goal of dividing board member duties. The law states that a corporation is managed by its board of directors, so it is simply not lawful for a director to not be attentive to corporate governance matters of the organization.

**President or CEO Involvement**

CEO and/or president involvement in the board selection process is a controversial subject. Having the president or CEO involved in the board selection process could lead to having a board that is captive to or greatly indebted to him or her. However, the president or CEO generally is the person who is committed to investing time and energy in the search for good board members.

Some feel, however, that having the president or CEO involved in board selection should depend on the size of the board. Many companies allow the board to decide in advance what qualities or areas of expertise (such as legal, financial, fundraising) are sought out in incoming board members.

Some select a middle ground — the president or CEO should be involved in the board member recruitment process but that selection should not be under his or her control. Balancing the involvement of the president or CEO with ultimate control of the selection process by the organization's board can be achieved by having the president or CEO meet with potential board members initially, and board members later can interview and complete the formal nomination process for those whom they see fit. In this scenario, the president or CEO does not have the ability to veto a prospective board member, but he or she is also not excluded from the process.

### For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.


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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.