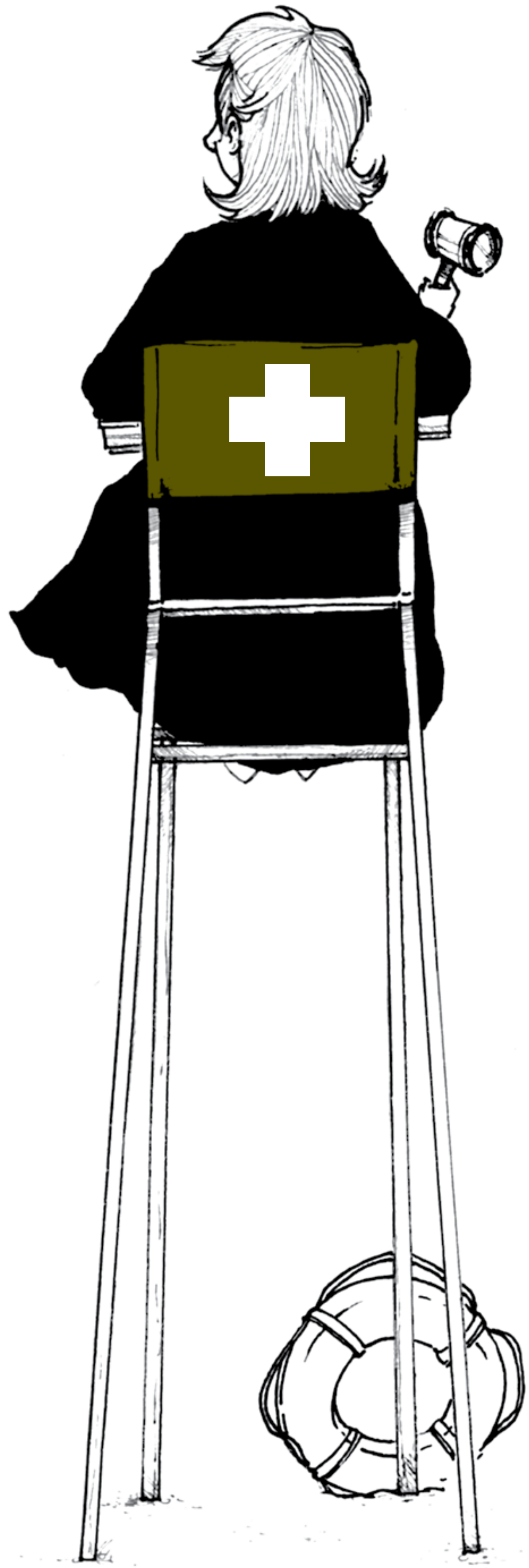
Best Practices

Protecting Directors of Nonprofit Boards

by Kathleen O. Thompson



Corporate boards have come under increased scrutiny in the last few years, starting with the collapse of Enron and WorldCom. The business sections of major newspapers have at times read like financial soap operas, with investors, business analysts, and Congress asking, "Where were the directors?"

The problems and concerns haven't been limited to massive, for-profit companies. In Washington DC, for instance, the volunteer board of the capital area United Way struggled to address a 60 percent decline in its annual fundraising drive because of questionable management practices. Nonprofit boards can't view themselves as immune from the Enron fallout.

ILLUSTRATION: DAVID HABBEN II

Congress responded to the Enron debacle with the passage of the Sarbanes-Oxley Act of 2002. The law directly affects only publicly traded companies—those with registered stock. It's designed to provide assurance to investors about the quality of corporate financial statements and senior management's actions. However, the solutions for Enron and WorldCom will affect nonprofits because tighter accounting, auditing, and legal standards that emerge won't differentiate between for-profits and nonprofits.

The American Bar Association sponsored an interesting program a few years back called "What Every Nonprofit Board Member Should Know." The program focused on how to comply with today's legal standards and suggested board "best practices." The panelists consisted of some of the country's leading legal authorities on the operations of nonprofit boards. Their observations and advice remain timely. The ABA panel warned, "Don't be blindsided. You'll be treated just like a for-profit business in any lawsuit. So get good advice to address risks and avoid problems."

The ABA lawyers provided insights to nonprofit boards so they can assess whether they need to initiate any corporate governance changes. One panelist observed, "A good board is always tinkering. An ineffective board tends to set its course and change nothing until there's a crisis."

Board Structure

The American Bar Association's program started with the premise that a board independent from management's control is essential, emphasizing three key points:

1. The board chair and members have written job descriptions defining responsibilities and how they differ from senior management's responsibilities.

2. Directors understand that their authority is derived from the board as a whole, and that individual directors have limited, if any, authority. One panelist observed, "A good board is governed by principles. A bad board is governed by personalities."

3. The board regularly evaluates how it's doing. Most boards do a poor job of evaluating individual board members. Sometimes it's good to have board term limits to allow fresh thinking and to address the need for new skill sets.

Frequently Asked Questions

American Bar Association panelists addressed several corporate governance issues of interest to many types of boards:

- What is the role of an honorary director? If your organization has such directors, it's important to define their role in writing, such as the ability to attend board meetings and participate in discussions. Make clear that honorary directors can't be counted toward a quorum and vote, can't be present when consulting legal counsel, and can't obtain confidential legal documents.
- What is the role of committees? Committees don't act in place of the board. Instead, effective boards control their committees. Remember, the whole board is accountable for

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actions by its executive committee. The board should review minutes from all committee meetings and make sure it agrees with the committee's actions.

• Should the board expand the role of its nominating committee? The American Bar Association panel recommended that nonprofits expand the nominating committee's duties to make it a "governance committee." A good nominating committee should annually develop a profile of the ideal board—job experience, expertise, and constituency representation. A committee with expanded duties could run a board orientation program and take charge of continuing board education. The committee could also organize an annual board retreat with an outside facilitator that involves a self-evaluation of the board's operation during the past year.

• What should board minutes include and exclude? On substantive issues, minutes should reflect the full extent of the discussion, summarizing the issue's pros and cons and reflecting the board's business judgment in making the decision. The minutes shouldn't delve into minutia and shouldn't try to quote everyone on each side of the discussion. The minutes should record all votes taken and list dissenting votes by name.

Duty of Care

Legally, the duties of any director are described as "duty of care" and "duty of loyalty." Board members' potential liability for wrongdoing or negligence will be measured on how they carry out these duties.

The duty of care covers the director's responsibilities to be informed in making decisions, to participate in the board's decision-making and oversight responsibilities, and to act in good faith. Carrying out these responsibilities legally is referred to as "the prudent man rule"—the evaluation of how someone serving in the capacity would be expected to act.

Practical suggestions to carry out this duty include:

• Schedule board meetings several months in advance so members can plan to attend;

• Provide information in a regular and timely manner, and distribute as much information as possible before the meeting so directors can review it in advance; and

• Have a standard meeting agenda with reports on significant actions taken since the last board meeting and with priority action items near the top of the agenda.

The "business judgment rule" is an important legal concept to measure director liability. Even when a board's decision proves to be unwise or unsuccessful, directors generally will be protected from a lawsuit arising from that action if they acted in good faith, with independent and informed judgment, and in a manner reasonably believed to be in the organization's best interest.

Duty of Loyalty

The duty of loyalty requires that a director act in the best interest of the organization to ensure confidentiality and avoid conflicts of interest.

Every board needs a conflicts of interest policy, and every director and officer should sign the statement annually. Furthermore, if anything changes during the year that might raise a possible conflict, directors must disclose it immediately.

The conflict of interest policy needs teeth; if there's a breach, termination from office or employment should be the likely outcome. Board minutes should note if any conflict of interest exists with a board member and how the board resolved the matter. The duty of loyalty also includes board members holding information in confidence. All discussions should be confidential to promote a candid exchange of viewpoints.

The American Bar Association panel strongly recommended that boards adopt a media policy. How should a board member respond when the local paper asks questions? What about a board member who voted in the minority about a sensitive issue? Panelists said a good board clarifies the process of handling dissension. Unfortunately, many nonprofit organizations have had unwarranted bad publicity because the board failed to address handling media inquiries.

Board/CEO Relationships

Many boards are amazed to learn that the CEO usually doesn't know what the board expects of him or her. The CEO is a strategic partner of the board but is also an employee of the company. The board of directors is responsible for providing a clear list of performance objectives for the position, and they should evaluate the CEO consistent with those stated objectives. Any contract with the CEO should be a real contract, and the board should spend the time necessary to establish expectations and the relationship between the board and CEO in writing, since this contract could form the basis of a terminated CEO's lawsuit.

Protection from Liability

The American Bar Association lawyers delivered a message that volunteer directors don't like to hear: The laws that try to limit directors' liability aren't very helpful. Every state differs in what protection it may provide to volunteers. One key protection every volunteer should look for is indemnification and director and officer (D&O) liability insurance.

Directors need to understand what D&O insurance covers and what limits exist in the policy's liability coverage. They must make sure areas excluded from coverage are particularly focused on the organization's policies and procedures. Even if liability insurance may not cover a specific area, an insurance policy may pay for defending against the lawsuit—also important coverage.

Directors should also understand how long the insurance policy protects them after they leave the board. The ultimate legal protection for a director is good governance. SR

ABOUT THE AUTHOR

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This article is adapted from Thompson's article "Directors in a post-Enron world," published in the *Credit Union Magazine* in April 2003.