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**I. THE CURRENT CORPORATE GOVERNANCE ENVIRONMENT AND THE RESPONSIBILITIES OF BOARDS OF DIRECTORS: A MATTER OF INTEGRITY.**

- 1. Organizational integrity is the overriding responsibility of Boards of Directors and senior management.**
- 2. What stakeholders need most from Boards of Directors and senior management is assurance of an organization’s integrity – including an assurance that organization’s values and culture support that integrity.**
  - Critical to an organization’s integrity is the “tone at the top.” The Board of Directors must be uncompromising in the selection, evaluation and retention of directors of high integrity and skill, who are knowledgeable about organizational governance and dedicated to the organization’s integrity and performance.
  - Equally important is the Board’s selection, evaluation and retention of executive management of high integrity and skill, dedicated to the organization’s integrity and performance.
  - The Board and senior management must then recognize their joint roles in assuring that the organization has, and practices, values that support a culture of integrity, fairness, trust, and high performance.
- 3. A key element of leadership is trust.** Boards and senior executives must be extremely sensitive to the signals they send to the organizations they lead. Signals include who is selected for Board service, who is hired to serve as a senior executive, what behaviors are endorsed or permitted at the Board, management and line employee levels, how people are rewarded, how customers and suppliers are treated, etc.
  - While reports on Enron, WorldCom, Tyco and a number of other highly publicized examples of corporate misconduct cite a variety of failures, underlying those specifics are often cultures of excess and greed, an imperial CEO/executive

management team and Boards which appear in many ways to have worked for management rather than the reverse. Similar issues have arisen in nonprofit organizations.

- Nothing undermines trust more quickly than compensation practices which are perceived as unfair or rewarding behavior which is not consistent with an organization's values.
- 4. Actual or perceived conflicts of interest detract from the integrity of an organization and its governance and must be avoided or properly dealt with.
- 5. An organization must have in place compliance systems and procedures that will give it early warnings of activities that would threaten the integrity of the organization – and when the warning comes that the Board will investigate the issue independently and without restrictions that might compromise the investigation.
- 6. An organization must select advisors and consultants, including lawyers and accountants, will act to protect the organization's integrity, and take issues that are important to the organization, to senior management and the Board of Directors to assure that they are acted on appropriately.
- 7. The bottom line of governance is that the ultimate authority for the governed entity is responsible for the entity's integrity. In many of the current corporate scandals the Boards failed because they did not take responsibility for the organizations' integrity. The directors did not see their organization's integrity as an extension of their own integrity – and ultimately that is the critical point.

## **II. TWO REACTIONS TO RECENT CORPORATE GOVERNANCE PROBLEMS BODE WELL FOR THE FUTURE: THE EMERGENCE OF RECOGNIZED BEST GOVERNANCE PRACTICES, AND THE EVOLUTION OF THE PROACTIVE BOARD**

### **1. First, the emergence of recognized good governance practices.**

- For several years there has been emerging a body of “best practices” in corporate governance. The sources are many:
  - Corporate governance practices articulated by Boards of Directors (this got a huge public push from General Motors a number of years ago).
  - Corporate governance practices authored by institutional investors such as TIAA-CREF and CALPERS, and proxy advisors such as Institutional Investors Services.
  - State and federal legislatures. State corporate laws for the most part do not distinguish between public, private and nonprofit organizations with respect to governance and the duties of directors.

- ❑ Various regulatory agencies, e.g. the Internal Revenue Service, the SEC, and the Comptroller of Currency.
  - ❑ Various self-regulatory organizations such as the New York Stock Exchange and NASDAQ.
  - ❑ State and federal officials charged with enforcement – note the recent actions of several state Attorneys General.
  - ❑ State and federal court decisions.
  - ❑ Various business organizations such as the Conference Board and Business Roundtable.
  - ❑ The National Association of Corporate Directors which has issued a number of Blue Ribbon Commission Reports on matters such as director professionalism, executive compensation, director and executive evaluation, detection of fraud, etc.
  - ❑ The American Law Institute’s Principles of Corporate Governance.
  - ❑ The American Bar Association Task Force on Corporate Responsibility.
  - ❑ Corporate Governance Ratings Agencies. Institutional Shareholder Services (61 metrics), Governance Metrics (625 metrics), The Corporate Library, Moody’s and Standard and Poors are providing corporate governance ratings for public organizations. Many of their metrics will also be a source of governance best practices.
- Good governance practices generally speak to the following subjects:
    - ❑ Board organization and leadership.
    - ❑ Board composition.
    - ❑ Director selection/orientation/education.
    - ❑ Board size.
    - ❑ Board processes.
    - ❑ Board service conditions.
    - ❑ Board duties.
    - ❑ Board compensation.
    - ❑ Board meetings (number, agenda, materials, etc.).

- ❑ Board/management relations.
- ❑ CEO evaluation and compensation.
- ❑ Director service (terms, resignation, age limits, etc.).
- ❑ Director and management service on other Boards.
- ❑ Director protection (indemnification, insurance, etc.).
- ❑ Evaluation of Board and Committee performance.
- ❑ Evaluation of director performance.
- ❑ Committee organization; compensation.
- ❑ Stakeholder interaction/communications.
- The ABA Corporate Responsibility Task Force Report.
  - ❑ The Task Force was charged with looking at corporate responsibility issues raised by a number of high profile corporate accounting and conduct issues which raised questions about the effectiveness of corporate governance, accounting and disclosure of public companies. The Report makes clear, however, that the issues raised are also applicable to private companies and nonprofit organizations.
  - ❑ The Task Force made a number of governance recommendations and compares those with recommendations made by the New York Stock Exchange, NASDAQ, the SEC and other selected organizations:

## **2. Next, the subject of proactive Boards.**

- It used to be the law and the practice that directors were not responsible for discovering problems; they were only responsible to act once there had been some kind of a “triggering event” – something that called their attention to a matter which needed to be addressed.
- That started to change with the development of the Federal Sentencing Guidelines which reduced corporate penalties for infractions where it could be demonstrated that the corporation had taken reasonable steps to avoid the conduct of which the corporation was accused.
- Board proactivity got a further push from the Delaware court decision in the *Caremark* case where Chancellor Allen articulated the proposition that Boards cannot wait for a triggering event, but must act proactively to assure that management puts systems and processes in place, and engages in active

monitoring, in an attempt to avoid illegal conduct, and to pick up warnings of such conduct.

- The current corporate scandals and resulting litigation are underscoring the importance of, and need for, proactivity at the Board level. This is supported by the Sarbanes-Oxley Act with its certification requirements and criminal penalties, the listing standards such as those proposed by the New York Stock Exchange and NASDAQ, governance rating agencies, current court decisions, as well as the positions taken by institutional investors and business groups, and the ABA Corporate Responsibility Task Force.

### **III. SARBANES-OXLEY AND ORGANIZATIONAL INTEGRITY.**

**1. First, recognize that many of the concerns dealt with by Sarbanes-Oxley are applicable to nonprofit organizations.** Nonprofits have had their share of highly publicized accountability issues.

**2. Sarbanes-Oxley's Underlying Principles: a focus on organizational integrity.**

- The Board is responsible for the integrity of the organization. Vigorous oversight of the organization and its management and greater proactivity are required of Boards.
- Director independence is essential.
  - Independence needs to be defined.
  - Executive sessions of the Board are an important aspect of Board independence.
  - Organizational resources should be utilized to support independent Board oversight.
- Auditor independence is essential.
  - Non-audit services must be scrutinized.
  - Partner rotation and firm rotation should be considered. Relationships between audit partners and management should be scrutinized.
  - Consider whether the organization's auditors should be prohibited from providing the following non-audit services, as is the case for publicly-held companies:
    - ❖ Bookkeeping.
    - ❖ Financial system design and implementation.

- ❖ Appraisal/valuation services; fairness opinions and contribution in kind reports.
  - ❖ Actuarial services.
  - ❖ Internal audit outsourcing services.
  - ❖ Management functions; human resources.
  - ❖ Broker-dealer, investment advisor or investment banking services.
  - ❖ Legal services and expert services unrelated to the audit.
- The Board should have an independent audit committee with authority to hire and fire the organization's auditors.
    - ❑ Audit Committee members should be financially literate; in larger nonprofits at least one should be a financial expert.
  - The Board should have an independent governance committee to oversee all governance aspects of the organization, including nomination of directors, evaluation of the Board, committees and individual directors, and articulation of the organization's corporate governance principles.
  - The Board should have an independent compensation committee which oversees director and executive compensation.
    - ❑ Loans to directors and employees should be prohibited. In some states loans are prohibited or conditioned by law. Question: is the advancement of expenses for indemnification purposes a loan?
    - ❑ IRS regulations, and other applicable laws and regulations, regarding compensation must be understood and complied with.
  - A corporation's attorneys' primary duties are to the entity and not management. Concerns affecting the well-being of the entity should be addressed with management and reported up the ladder.
  - The organization's financial and business information should fairly present, on a current basis, the condition of the organization. The Board should consider the subject of CEO and CFO certification to the accuracy of the information.
  - The organization should have a code of ethical conduct applicable to directors, executives and employees (and independent contractors and suppliers).
    - ❑ The Board is responsible for compliance, and should see that procedures and processes are in place to monitor the organization's compliance with laws, regulations and its own policies.

- Conflicts of interest must be avoided, and carefully dealt with when they occur.
- Corporate information must not be tampered with or destroyed if relevant to an actual or prospective government investigation or proceeding, or private litigation.
- Corporate employees who alert the organization to compliance issues must not be the subject of retaliation.
- Board, committee and director performance should be periodically evaluated.
- The Board and its committees should have the authority and resources to hire independent advisors to assist with the performance of their duties.

### **3. Observations.**

- We will continue to see a shift to proactive Boards. Vigorous oversight will become more the norm.
- There is a heightened focus by Boards on governance of the organization, and the organization and leadership of the Board.
- There is a greater focus on the audit committee, its composition, responsibilities and performance.
- Certification on the part of the CEO and/or CFO will be utilized by Boards of nonprofit organizations. Certifications are also being used by CEOs and CFOs at other levels of responsibility in their organizations.
- State legislatures will consider, and are considering, enacting provisions similar to many of those in the Sarbanes-Oxley Act; or preparing their own version of corporate disclosure/conduct requirements.
- Regulators will look at the best practices articulated by other regulatory agencies and self-regulatory organizations and begin to incorporate these into regulations affecting, and settlements with, organizations.
- Without regard to what the regulators do, Boards of Directors are looking at examples of good corporate governance practices, and bringing those practices to the organizations, public or private, for-profit or nonprofit, that they govern.
- Good governance policies adopted by various organizations will become benchmarks for regulators as well as litigants.
- The subject of conflicts of interest, already a focal point for the press, will receive even more scrutiny from Boards, regulators and litigants.
- Loans to directors, officers and employees are receiving increased attention from regulators.

- Non-audit services provided by auditors are being increasingly scrutinized, and this is true of services provided by other consultants as well, to minimize conflicts and insure objectivity.
- The amount and structure of Board and committee compensation in the for-profit sector is changing, and this will be an increasing issue for certain types of nonprofits.
- After the New York Stock Exchange executive compensation issues, Boards will increase their efforts to manage this subject more appropriately.
- Codes of ethics and compliance policies are being routinely adopted by organizations, and Boards will more carefully monitor adherence. Given the attention focused on the waiver of certain conflicts of interest by the Enron Board of Directors, Boards will (and should) be very cautious about waiving conflicts or suspending ethical conduct policies.
- Document retention policies are being adopted by more organizations, and Boards and management will more closely monitor compliance.
  - Document retention policies apply to written and electronically stored data. Email is worthy of special note, and organizations should address their rights to access and view employee email as well as sending, forwarding and saving email messages.
- Boards and Board committees will more frequently engage independent counsel and other advisors to assist them in the performance of their duties.

#### **IV. HOW CAN BOARDS USE GOVERNANCE TO BUILD ORGANIZATIONAL VALUE?**

1. **Governance is a discipline different from management. It's about proactive, vigorous oversight.** Who populates most Boards? Often it's people who have excelled at management.
2. **Integrity is everything.** It is the root of stakeholder and public confidence in an organization. Organizational integrity starts at the top, i.e., the Board of Directors and senior management. And donors are becoming increasingly interested in this subject.
3. **Organizational culture and Board/management leadership is critical.** Boards must take more responsibility for ensuring that the Board and management has appropriate leadership, and that leadership is held accountable. The Board must actively monitor the culture of the organization to assure that it reflects ethical values and trustworthiness, and must require management to build/maintain an ethical culture.
4. **Boards must take more responsibility for compensation, perks and incentives.** Recent disclosures of compensation levels and perks paid to senior management of

organizations have incensed the public and their political representatives. Compensation plans for senior executives and other managers must be reviewed to assure improper behavior is not incentivized. Boards must realize that excessive director and executive compensation reflects poorly on their independence, integrity and judgment.

5. **Boards must carefully assess actual and perceived conflicts of interest.** Conflicts of interest in general, but particularly involving directors, senior management and key advisors, must be carefully assessed, and independent advice sought where necessary. Like the compensation issues, unresolved or poorly resolved conflicts of interest reflect badly on Boards' independence, integrity and judgment.
6. **Boards must pay more attention to the organization's human capital.** Boards have always accepted responsibility for the organization's financial capital. They must devote equal attention to the organization's human capital.
7. **Directors must pay close attention to their core duties: care, loyalty, good faith, compliance and oversight.**
8. **Boards must strive to understand risks, pay attention to warnings and confront problems promptly and forthrightly.** Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. Warnings need to be heeded and promptly investigated. Investigation means a thorough effort to obtain all relevant information, using independent resources where necessary to assure objectivity. History provides ample lessons of the disastrous consequences of cover-ups. A cautionary note: When conducting an investigation pay close attention to issues of attorney-client privilege.
9. **Transparency is good; obscuring reality is bad.** Transactions, schemes or practices which make it difficult for those who rely on the organization's financial information to clearly understand that information will be questioned. Boards need to be increasingly aware that if third parties' decisions are made based on potentially misleading omissions or information, litigation and government investigations may ensue.
10. **Targets are good; financial performance obsessions are bad.** Agreed that plans, targets and accountability are good. But not when the targets are unrealistic or the pressures or incentives to achieve them so great as to result in deliberate distortions, or the use of "cutting edge" accounting or business practices. A survey by *CFO Magazine* found that 17% of CFOs, many from the nation's largest companies, had been pressured by CEOs one or more times in the last five years to misrepresent financial results. Directors need to be aggressive about investigating and ending that pressure.
11. **Monitor corporate disclosures.** Boards are increasingly aware of the organization's responsibility for accurate, complete disclosure to banks, creditors, insurance companies, government tax and regulatory authorities, and others who rely on or

require the organization's business and financial information. Boards must also be aware of the many ways in which the organization provides information, e.g., public comments by management, management conduct, media interviews, press releases, websites, broadcast or directed email, regulatory agency filings and a multitude of forms and applications for other third parties.

12. **Boards must be extremely conscious of the signals they send to the organizations they govern:** signals which come from their own conduct, who they nominate as directors, who they hire as the CEO, what conduct they endorse, what values they espouse directly and indirectly, how they deal with behavior which is antithetical to those values, and situations which test those values – it's about the culture of the organization for which they are ultimately responsible.
13. **Directors need to be schizophrenic:** vigilant overseers, on the one hand, and effective, constructive collaborators on the other.
14. **Boards must focus on reputational value: reputations take years to build; moments to lose.** For most organizations their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and organizational conduct which may compromise an organization's reputation for integrity and trustworthiness with its various stakeholders. As we've seen the consequences of a breach of trust can be brutal.
15. **Good governance practices.** Good governance in actuality, not just in appearance. The Boards of many organizations now in the news are populated with individuals who have excellent credentials. Often the appropriate governance documents and Board structures are in place. However, good governance is about organization, process, education and **EXECUTION**. And finally **EVALUATION** -- evaluation of management, principally the CEO/Executive Director, evaluation of the Board, and evaluation of directors.

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