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Confronting Liability Risks: Corporate governance on non-profit boards

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National Association of Corporate Directors – New England Chapter

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Basic Duties

- Duty of Care – follow good process
  - Business judgment rule: "*The presumption that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest. The rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, with due care, and within the directors' or officers' authority*." Blacks Law Dictionary
  - Corporate "waste": *Is there an "exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade"? In re Citigroup Shareholder Derivative Litigation, C.A. No. 3338-CC, 2009 Del. Ch. LEXIS 25, 54 (Feb. 24, 2009).*
- Duty of Loyalty – No conflicts of interest
  - Form 990 "independence" ≠ "independent" for conflict purposes!
  - Annual D/O questionnaires
  - Form PC requires disclosure of all related party transactions
  - Consider adopting super-majority voting for related-party transactions?

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Basic Duties: Board Delegation Issues

- Nonprofit directors are more strictly constrained in their ability to delegate authority than are directors of for-profit corporations
  - A nonprofit board could not delegate authority to a CEO to enter into a contract with a private company allowing that company to be the exclusive promoter of the Boston marathon. Bos. Athletic Assoc. v. Int'l Marathons, Inc., 392 Mass. 356 (1984).
  - The board of a charitable corporation could not delegate control of a substantial part of the corporation's assets to a separate trust. Mass. Charitable Mechanic Ass'n v. Beede, 320 Mass. 601 (1947).

Expanded Form 990 Requirements

- Revised Form 990 Released January 11, 2012:
- Governing Body Disclosure
  - Delegation of broad authority?
  - Material differences in voting rights among members?
- Compensation Review
  - Requires annual (a) approval by board or Comp Comm by board members independent of transaction, (b) use of peer data, (c) contemporaneous recordkeeping of deliberations
  - Encourages full explanation of compensation determination process
- Clarification of “independence”
  - Board member now considered “independent” even if director or a family member = “key employee” of an entity engaged in business with NFP
  - Compensation for *board* work does not render director non-independent; compensation for *management* work does
- Board must see Form 990 before filing

Who are the oversight authorities?

- Attorney General's Office, Division of Public Charities
  - Enforcement power limited by BJR, but big bully pulpit
- IRS – must be solely devoted to a "charitable purpose"
  - *Private Benefit*: "*No part of an organization's net earnings may inure to the benefit of an insider*." (*i.e*., director, officer or key employee) This includes unreasonable compensation, such as *excess benefit transactions.*
  - *Legislative Activity:* Prohibition on substantial legislative activities.
    - Consider the time and expenditures devoted to proposing, supporting or opposing legislation, particularly in the context of other activities.
  - *Political Campaign Intervention*: Prohibition on directly or indirectly participating in, or intervening in, any political campaign – including making contributions to political campaigns. Non-partisan, "voter education activities" may be permitted in certain circumstances.
    - Consider the context and timing of advocacy communication.
    - Consider the role of candidates invited to speak at organization events – could the questions, topics be considered bias?
- Accrediting Authorities

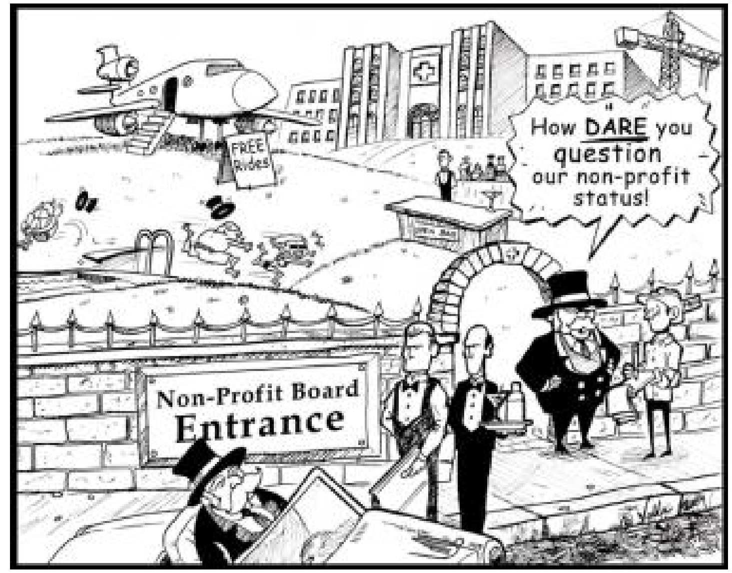
Here's what could happen . . .

NONPROFIT NEWS

Smithsonian scandal is the latest nonprofit sector black eye

CHARITY WATCH

CharityWatch Hall of Shame



MSNBC

For U.S. charities, a crisis of trust

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CEO misbehavior – Beth Israel/Paul Levy

- Hospital CEO began relationship with female employee whose position was newly-created and not filled after she left
- Board members became aware as early as 2003; Board Chair raised concerns with CEO
  - 2004: New board Chair again raised concerns with CEO
- February 2009: CEO convened small group of senior managers, who recommended employee leave. Employee laid off in November 2009
- March 2010: Board received an anonymous letter from "concerned employees of BIDMC" alleging CEO had improper relationships with two female employees

CEO misbehavior

- Board response:
  - After 7 years, Board Chair investigated allegations; retained CEO but expressed public disappointment in his conduct and fined him $50,000
  - At least one Board member threatened to resign if CEO terminated
  - *"We are disappointed in these circumstances, but the board expressed unanimous continued confidence in Mr. Levy's leadership of the medical center."*

    -Stephen B. Kay, Board Chairman

CEO misbehavior

- Result?

- January 2011: CEO resigned, stating that his decision was unrelated to the controversy

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CEO misbehavior – Other Examples

- *American Red Cross*
  - CEO conducted an improper relationship with a female staff member
  - Board asked for his resignation within 10 days of learning about the relationship; CEO resigned in November 2007
    - Total tenure was less than six months
  - Board undertook extensive audit of all money spent by CEO to ensure funds not misappropriated
- *United Way of the National Capital Area*
  - CEO defrauded the charity of $500,000
  - Board members who pushed for an investigation were initially dismissed; later, the entire board of directors was replaced
  - CEO sentenced to two years in prison in 2004; donations plummeted

CEO compensation

- Northeastern U's Initiative for Investigative Reporting
  - Students analyzing CEO compensation from publicly available_tax returns for over **22,000** organizations across Massachusetts
- Severance packages, perks are key target
  - Severance not reported on Forms PC until termination
  - BC/BS CEO awarded total $10.5M ($6.2M accrued; $4.3 severance) upon resignation; directors paid fees of up to $89,000
  - AG investigated; found inadequate performance review process, relying primarily on CEO self-assessment and proposal, with no system for input from senior management or external contacts
    - AGO oversight of all sr. management severance provisions
    - $4.3M credited to premium payers
    - New CEO voluntarily agreed to comp below that of peers
    - Split of CEO and Chair roles
    - Board suspended board compensation

IRS Penalties for Excess Compensation

- *"Excess Benefit Transaction"* = value of the economic benefit provided by the organization exceeds the value of the consideration received by the organization.
  - Penalties:
    - Non-profit status may be revoked
    - Board members personally fined 10% of excess benefit
- Example:
  - *A board member is on the committee that approves the compensation of the organization's new president. The board member knows that the fair-market value of the president's services does not exceed $150,000. Nevertheless, the board member votes to approve setting the president's compensation at $250,000. The board member may be subject to an excise tax of $10,000 (10 percent x $100,000 excess benefit) as an organization manager.*

  Richard V. Smith, *Excess Benefits: A Potential Pitfall for Nonprofit Insiders*, Society for Human Resource Management (Jan. 7, 2011)

Heightened scrutiny of CEO and board compensation

- 5/12/12: Senate passed provisions affecting NFPs
  - AG to review executive compensation at all registered public charities and report results to MA legislature
  - Requires waiver for any NFP operating primarily in MA:
    - Compensation of any D/O of more than $500K, for public charities with >$1M in gross revenues
    - Compensation for independent officers or board members
- As of 2012, AGO now requires written justification of "basis and rationale" for Board compensation
  - But note: IRS 990 guidelines provide director still "independent" even if receives compensation

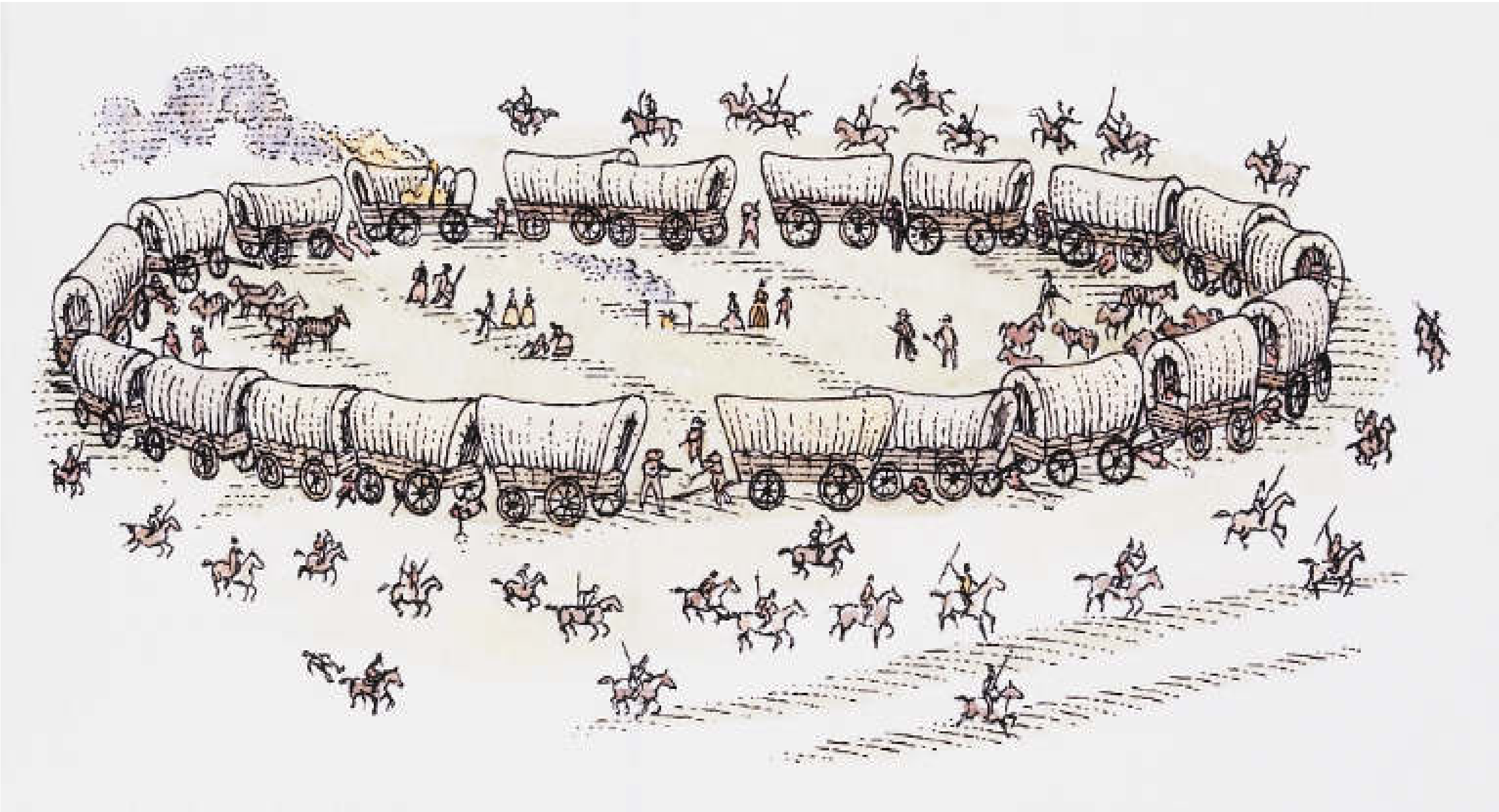
Sarbanes-Oxley Act: Director Bar

- § 305(a)(1) and § 1105 : The SEC may proceed by seeking injunctive or equitable relief or by expedited cease-and-desist proceedings to prohibit any individual who has violated the antifraud provisions of § 10(b) of the '34 Act from acting as an officer or director of any public company if the person's conduct demonstrates "unfitness" to serve.
  - Previous standard required "substantial unfitness"
  - SEC interprets the standard as including a "single serious breach of the public trust." *Remarks of Stephen M. Cutler, Former Dir., SEC Div. of Enforcement*, *available at* http://www.sec.gov/news/speech/spch538.htm.
- Directors of for-profit companies who sit on boards of nonprofit organizations issuing securities (e.g., bond issuances for capital projects) must pay particular attention to disclosures
  - "When investors have been deceived, you can be sure that neither the courts nor the [SEC] appreciate technical excuses."
    Remarks of Martha Mahan Haines, Chief of the SEC Office of Municipal Securities, available at http://www.wallerlaw.com.sitemason.com/files/AHLApdf.pdf

Dodd-Frank Act: application to non-regulated entities and individuals

- § 929P: SEC may impose civil monetary penalties in cease-and-desist proceedings under certain securities laws, even against those entities and individuals not regulated by the SEC
  - Administrative proceedings offer a faster approach (with limited discovery) than federal court
  - Scope and enforceability of § 929P is currently uncertain
    - Rajat Gupta challenged the SEC's administrative proceeding against him in federal court, arguing that the proceeding violated his due process rights by denying him a jury trial, and should not be applied retroactively (*Gupta v. SEC*, 11-cv-1900 (S.D.N.Y.)
    - Narrow ruling by Judge Rakoff, S.D.N.Y.: Gupta's challenge can stand - his case should be tried in federal court

Board's Primary Duty: Be Committed to the *Organization*, Not the *Individual*



Other Best Practices

1. Ensure board has relevant expertise: financial, compensation, operational
2. Ensure majority of board members = “independent”
   - Diligently follow the conflict-of-interest policy
   - Independence is both an adjective and an action: don’t “circle the wagons”!!
3. Process is IMPORTANT: Board must have all the information it needs, and conduct due review of same
4. Have appropriate committees composed solely of independent board members:
   - Audit Committee -- for financials, and potentially for review of complaints
   - Governance and Nominating Committee
   - Compensation Committee

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Other Best Practices, cont'd

5. Compensation issues loom large: ensure
   - Comp Committee is truly independent of CEO
   - Peer group is representative
   - Committee has access to input outside of CEO
6. Adopt Code of Ethics, and Document Retention and Information Security Policies
7. Do not delegate core mission to management

A Final Reminder of What to Say

“We’ve been confident in the way we’ve proceeded in the past, but we’d be remiss not to acknowledge that others may see it differently. That’s why we’re taking a careful, hard look at what we felt we did right the first time.”

QUESTIONS?

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