Boards Must Change the Ways They Do Business

Nonprofits are in crisis. Here's how to protect your organization.

BY GARY SNYDER

Nonprofits can't ignore the scandals that have rocked the corporate world. The nonprofit community must confront many of the same issues as the for-profit world. Both have been slapped with a new notion of what it takes to protect their boards and officers from claims of malfeasance.

The Government's Response

In response to the corporate failures, Congress has passed new federal legislation. The Sarbanes-Oxley Act of 2002 (SOA) is the new standard for all boards. It raises the consciousness of corporate and nonprofit boards by doing the following:

- **It aims to make boards** more independent and knowledgeable.
- **It underscores** the fact that the board has the ultimate authority.
- **It gives boards** (and board committees) greater responsibility for monitoring the actions of management.
- **It makes boards less passive** and more active.

These changes and new obligations will be on the front burners of boards for years to come. They will revolutionize how boards operate, particularly in the areas of financial disclosure, excessive compensation, loans to officers and directors, and conflicts of interest. The centerpiece of the bill is the way the audit committee conducts its business.

The issues addressed in the federal legislation are similar to issues that need addressing in the nonprofit world. Both corporate and nonprofit organizations want reliable financial reporting, effective operations, compliance with laws and regulations, and methods to evaluate the board's practices.

The Corporate Board Response

With boards under increasing scrutiny, members have been vacating their positions. Many of approximately 45,000 directors of public companies expect to turn over in the next 12 months. The focus of recruiting new board members will be on those with financial skills. The exodus of senior executives will exacerbate the problem of finding board members with the critical skill set.

Scores of board members are taking a closer look at the liability coverage that is supposed to protect them. Without appropriate coverage, a director (or officer) has exposure for court costs as well as cash settlements and judgments.

Large corporations are seeing their insurance premiums soar 200-400 percent. However, escalating premiums are only the tip of the insurance iceberg. Corporations are now being asked to assume more of the risk. For example, corporations have to cough up a larger deductible with lower limits of liability coverage. Even the lower coverage has a more narrowed scope with numerous policy exclusions.

The Nonprofit Board Response

Nonprofits face similar challenges. They, too, confront great scrutiny and are having trouble filling board seats. Over one and one-half million nonprofit board seats are vacant or being turned over. That figure is escalating. Boards are aging, with 82 percent over the age of 40. It is increasingly hard to find new candidates. Top-tier board members are leaving, and their positions aren't being filled by people with comparable skills. This void augurs mediocre decision-making and increased legal exposure.

With more than 1.5 million nonprofits and annual contributions over $212 billion, board members feel vulnerable to large claims from disgruntled contributors and other stakeholders.

Nonprofit World • Volume 21, Number 4 July/August 2003
Published by the Society for Nonprofit Organizations
5820 Canton Center Road, Suite 165, Canton, Michigan 48187
734-451-3582 • www.snpo.org

Increasingly concerned with protecting their assets, board members are asking questions about their D&O (directors' and officers') coverage. With escalating premiums (ballooning by 58.3% on average, with some increasing upwards of 300%) and decreasing protection, D&O insurance is on the agendas of all boards. It is becoming a major issue in the budgetary and planning processes.

How to Safeguard Your Organization

Besides routine coverage against exposure to risks in the form of claims and lawsuits in the areas of workers' compensation, employee health insurance, unemployment, property and casualty, professional liability, corporate auto, and surety bonds, the nonprofit board must indemnify itself against claims alleging intentional harm attributable to governance or mismanagement of the organization.

Many nonprofits are under the misimpression that they don't need insurance because the state in which they operate has statutory protections against "civil wrongdoing." While nonprofits may have a certain degree of charitable immunity, that doesn't mean they can't be taken to court.

The most common form of exposure for nonprofit boards of directors is "wrongful discharge," frequently brought by the executive director. Another common exposure is "breach of contract" brought by the board against the executive director.

Other areas of concern are becoming more prevalent and may precipitate a lawsuit. These include:

- **incomplete conflict-of-interest** disclosures
- **breaches** of fiduciary duty
- **board members' excessive return** on investment
- **lack of documentation** that policies are in place and being followed
- **use of the imperial staff model** and lack of follow-up on day-to-day matters.

Boards are aging, with 82 percent over the age of 40.

Lawsuits of this nature signal poor management and governance. When such a lawsuit is filed, it is often doubtful whether the nonprofit organization will survive.

The relatively low-risk environment of nonprofits is increasingly shifting to a higher level of risk. The accountability bar is being raised. To be sure your organization is up to the new standard, follow these rules:

- **Obtain directors' and officers' liability insurance** with broad coverage. Be sure it includes a duty-to-defend option so that the insurance company will pay for your organization's legal defense in case of a lawsuit against you.
- **Recruit board members** with skills in financial, technology, public relations, marketing, and entrepreneurship areas.
- **Never allow your organization** to make personal loans to any director or officer.
- **Educate board members** about your organization's finances. Surveys show that the vast majority of board members don't know how to read their organizations' financial statements. Your organization can't afford such ignorance.
- **Form an independent audit committee** to retain and supervise auditors.
- **Be sure all compensation is reasonable**, based on salaries at comparable organizations.
- **Involve your board** in all important decision-making.
- **Create** written employee policies. Document the fact that people understand and follow these policies.
- **Adopt a code of ethics** for senior financial officers.
- **Set up** an internal control system to keep on top of potential problems, and review these controls often.
- **Make your organization's financial information** readily available to all stakeholders.
- **Have procedures in place** to follow up on any allegation of mismanagement, improper governance, or inappropriate behavior.
- **Refuse to tolerate** passive board members. Every board member must be an active, contributing participant. ■

Resources

"Keep Your Board Above Board: What You Need to Know about Sarbanes-Oxley," First Alert, *Nonprofit World*, Vol. 21, No. 1.

Lapin, David, Donald Grunewald, and Barbara S. Frees, "Choosing the Right D & O Insurance for Your Board," *Nonprofit World*, Vol. 12, No. 1.

Ross, Frank, "The Audit Committee: Why You Need One, How to Form One," *Nonprofit World*, Vol. 6, No. 6.

Sopher, Marti, "Setting Up a Control System for Your Organization," *Nonprofit World*, Vol. 16, No. 3.

"Standards for Nonprofit Boards Are Being Raised," First Alert, *Nonprofit World*, Vol. 21, No. 3.

These resources are available from the Society for Nonprofit Organizations' Resource Center, www.snpo.org.

Gary Snyder is managing partner of Nonprofit Management Group (6584 Pleasant Lake Ct., West Bloomfield, Michigan 48322, 248-324-3700, nmg_central@hotmail.com), a consulting firm developing integrated solutions for organizations in transition.