

Council of Michigan Foundations Conference Keynote, October 10, 2005

By Deborah S. Hechinger

“On September 30th, the Panel on the Nonprofit Sector closed its comment period on the most recent set of recommendations on the governance, accountability and transparency of the nonprofit sector. These are supplementary to the more than 120 recommendations in the Final Report in June 2005.

The Panel’s work has been far reaching and expansive as it sought to address concerns that had been raised by various Congressional committees, most notably the Senate Finance Committee. Putting the ideas of congressional staff to the acid test of reality, the Panel has tackled a large number of issues, ranging from donor advised funds to filing and disclosure suggestions, to non cash contributions of both appreciated property and conservation and historic façade easements. Many of the recommendations deal with governance issues – the role of the board, transactions with and by the board, and the composition and policies of the board. Befitting the great state of Michigan’s leadership in the nonprofit sector, the Panel included Dotty Johnson, president emeritus of the Council of Michigan Foundations, Bill

Richardson, President and CEO of the W.K. Kellogg Foundation, Sam Singh, President and CEO of the Michigan Nonprofit Association, and Bill White, President and CEO of the Charles Stuart Mott Foundation.

In many cases, the Panel proposed new laws and regulations; in other cases, the Panel identified good practices which it urged the nonprofit sector to follow.

Why so much focus on boards and the way they behave and operate? The National Panel recognized, as do most of us in the charitable sector, that the board is the primary mechanism for accountability in a charitable institution. While there are various state and federal laws and regulations that address the behavior of foundations and charities, there is no single government agency regulating the accountability and transparency of charitable institutions like the Securities and Exchange Commission does for public companies. From a day to day perspective, it is the board to which the CEO and management are accountable. It is the board which state and federal authorities hold ultimately accountable. And in the absence of easy ways to assess success like profitability for for-profit boards, it is the nonprofit board

to which the public turns to assure management competence and mission success.

As importantly, foundation boards can play a key role in the foundation's success. In addition to serving as an oversight mechanism, foundation boards bring experience, diverse viewpoints, and critical skills to foundations. They serve as sounding boards for chief executives when they listen to news, both good and bad. They oversee portfolio investments, audits, and grant-making. Foundation directors press the staff for strategic impact in grants. Community foundation boards attract new pools of resources. And all good foundation boards model good governance practices when they design and implement conflict of interest and whistleblower policies, and when they engage in regular board self assessments.

But not all foundation boards live up to these standards. Given the drumbeat of negative press and congressional concern over the past couple of years, it is no surprise that the Panel focused so closely on ways to improve foundation governance. They know what has been proved in the

corporate sector – that good governance at the board level make a real difference in the effectiveness of the organization.

Good governance at foundations is predicated on boards that understand the particular role they must play as leaders of charitable organizations. While it's true that foundations are always accountable to their donor's intent, it is also true that they are charitable organizations, established to do public good with tax deductible money. Because of this special status, foundations are also accountable to the public trust.

As board members of their institutions, they are there to lead. And because these are charitable organizations that they are leading, board members of foundations are also there to serve. While many serve as volunteers, some directors are compensated. In those cases, they are required to deal fairly and justly with their organizations.

With the essentials of good governance in mind, the Panel focused on director compensation and independence, as well as conflicts of interest.

The way a board handles these issues directly affects the board's ability to put the foundation's interests first and to make good decisions on its behalf.

In the compensation arena, the Panel discouraged the practice of compensating trustees, a practice which is found in a number of foundation boards, but rarely in public charities. Noting that some foundations find it valuable and important to compensate trustees, the Panel urged those foundations to disclose the amount and reasons for compensation, as well as the method used to determine the reasonableness of that compensation. The Panel also recommended that Congress increase the penalties on board members and other managers of charitable organizations who approve excessive compensation.

Secondly, the Panel recommended that Congress amend the Internal Revenue Code to provide that penalties could be incurred in two circumstances - when foundation board members or other managers knew that the transaction was improper *and* also when they “should have known” that it was improper, i.e. when they failed to exercise reasonable care.

And third, they recommended Congress increase penalties on foundation board members in various circumstances. In situations where foundation board members or other managers *received* excessive compensation, the

Panel recommended that they be forced to repay the original amount and a penalty of up to 25% of the excess amount. In other situations where foundation board members *approved* excessive compensation *for others*, the Panel recommended that penalties be increased from 2.5% to 10%, up to a cap of \$20,000 per transaction. Finally, in cases in which directors or other foundation managers inadvertently violate these provisions, the Panel recommended that the Secretary of the Treasury have the power to abate such taxes as long as the individual did not receive an excess benefit and the foundation was not harmed.

As an aside, I should note that the Panel's recommendations on penalties for approval of excessive compensation were extended to any transactions subject to the "self-dealing" prohibitions of the Internal Revenue Code. Those rules prohibit private foundations from engaging in certain transactions with board members, foundation managers and related parties without regard to whether the transactions are fair or even advantageous to foundations. With the Panel's recommendations on increasing penalties, violations of the self-dealing rules will also be more costly.

For those foundations that wish to continue to compensate their trustees for their board service, I suggest following the recent recommendations of the Board of Directors of the Council on Foundations in a new, short paper titled “*Determining Reasonable Compensation for Foundation Directors and Trustees.*” The paper walks through ways to determine whether foundation compensation for trustees is, in fact, reasonable.

And lastly, I leave you with this thought. Beyond reasonableness, ask yourself whether compensation for service as a board member of a foundation is really necessary or appropriate. Few public charities do it. Most foundations don’t do it. Many would find it an honor to serve. Remember why foundations exist and think about their tax exempt status and their leadership role in the charitable sector. Balance all of that very carefully with your perceptions of the *need* to compensate your trustees, and then do the right thing.

Turning to the importance of “independence” on charitable boards, the Panel recognized that one prerequisite of independence is having a minimum number of directors and so it recommended amending tax regulations to require all 501c3’s, including foundations, to have at least 3 board members.

The Panel did not recommend requiring foundations boards to have a minimum number of “independent” directors, as they did for public charities, but they did recommend that private foundation be required to join public charities in disclosing which, if any, of their board members are independent on their forms 990 PF’s. They also recommended that foundations and public charities adopt and enforce conflicts of interest policies, and that the IRS require disclosure of the existence of such a policy in the 990’s.

It is understandable why the Panel chose not to require “independence” in foundations. First, the need is perceived to be less because foundations are subject to the self-dealing prohibitions. Second, family foundations and corporate foundations have significant challenges in building independence into their boards. But independence – the capacity to make up one’s own mind - on boards can improve decision-making.

And, in my view, while it’s easy to categorize independence in terms of compensation arrangements with board members, that may not be the best way to judge it.

Don't get me wrong. Reducing related party transactions, and having and following conflict of interest policies, do help board live up to their compliance responsibilities and they do reduce the potential for abuse. I wholeheartedly support them.

But we know that they are not enough. World Com and Enron had boards "world class boards", boards full of prominent individuals who did not have transactions with the company. These were boards that had codes of ethics and conflict of interest policies. But look what happened to their organizations.

What we really need in board members is *independent-mindedness*.

Independent-mindedness enhances decision-making, brings diversity of views and experiences to the table, prevents conflict of interest transactions, and promotes the perception of professionalism in the public's mind. For these reasons, *independent-mindedness* helps foundation boards move beyond compliance to effectiveness.

Independent-mindedness, though, can be hard to come by in foundations, as in other boards, for a number of reasons.

Often board members are selected by the CEO. They sometimes have a relationship with each other that supersedes their loyalty to the donor or the organization.

In other cases, boards don't know what they are supposed to do. They think their job is to read the materials sent to them, ensure no wrongdoing, and stay true to the mission. That's clearly not enough. They need to ask questions, test the validity of recommendations, engage in strategic thinking, and press for results. BoardSource's recent work, *The Source: Twelve Principles of Governance that Power Exceptional Boards* highlights this, noting that "exceptional boards institutionalize a culture of inquiry, mutual respect and constructive debate that leads to sound and shared decision-making."

Lastly, boards have their own culture, one of "going along to get along." This tendency can be exacerbated in situations in which the CEO and the Board Chair are one and the same. That's why the Panel recommended as a matter of good practice, that those positions not be held by the same individual and suggested, that if foundations felt that to be necessary, they

appoint a “lead director,” consistent with the practices of publicly held companies.

All of this is food for thought as you operate your foundation. Of course, one size doesn't fit all and what is appropriate for one foundation may not work for another. But if your goal is good decision-making, explore ways to bring independent mindedness to your board. Try independent directors, and if that doesn't work try including multiple generations or outside directors or advisors. And find ways for your foundation to hear diverse voices from the communities and constituents you serve.

As the Panel winds up its work and all eyes turn to Congress to see what kind of legislation it will propose, none of us know what will happen. Sure, the charitable sector took a black eye when stories of abuse and misbehavior were splashed across the front pages of newspapers from coast to coast, but all nonprofits, public charities and foundations alike, have a great deal to be proud of in our everyday work and, most recently, in the wake of Hurricane's Katrina and Rita. Every day, we hear of instances of foundation leadership, and of public charities on the ground, all working to help the displaced victims of the wrath of those storms. Nonprofits have been there

to provide clean water, food, shelter, and hope to the hundreds of thousands of people in Louisiana, Texas, Mississippi, and Alabama.

We know that legislation may be coming, and much of it will be good for the sector if Congress follows the lead of the Panel. But with Congress's attention diverted to those crises, a new Supreme Court nominee, and the war in Iraq, many of us wonder what kind of legislation will be introduced and when.

We don't have to wait for legislation to do the right thing. In outlining a number of best practices, the Panel itself recognized that it was the nonprofit sector itself that held the reins of its own destiny. With their recommendations in hand, let us move forward together to improve governance in foundations and public charities alike. In doing so, we will strengthen our boards and our organizations, improve accountability, and build and rebuild the trust of government and the public in our sector.”

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