GUIDELINES FOR GOOD GOVERNANCE

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GOVERNANCE AND "BEST PRACTICES"

Charities play a significant role in our society. They provide services and grants in a wide variety of areas that are of importance to the community, ranging from hospitals to educational institutions to museums to organizations dedicated to assisting those in need. The purpose – or mission – of these organizations drive the activities it carries out and the board of directors is responsible for overseeing management to ensure that this occurs.

Governance, transparency and accountability are critical issues for all charities. Effective governance, transparency and accountability leads to increased public trust in the organization and a greater willingness to donate funds and services. The ultimate goals should be an active and engaged board. In this respect, the experience of boards in the for-profit world provides a useful point of comparison. Boards of for-profit organizations have worked to restore public confidence and increase investment in the wake of several highly public governance failures. The steps taken by boards of for-profit organizations – including those required by reforms embodied in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and related rules and regulations – have led to increased board engagement. Boards of charities may wish to embrace these measures that have become "best practices;" although not required by law, the IRS has articulated "good governance" standards for all tax-exempt organizations.

I. ROLE OF THE BOARD AND FIDUCIARY DUTIES – AN OVERVIEW

The role of the board of directors of a charity is similar to the role of a for-profit board. In both cases, the organizations are tasked with managing other people's money and in both cases they are judged by their success in doing so. Yet, there is a very key difference: in the for-profit context, shareholders are able to hold corporate directors and officers accountable, whereas in the charitable context there is no mechanism by which the organization can be held accountable when it fails to act in furtherance of its mission. Although the government (such as the Attorney General and the Internal Revenue Service) plays an important role in policing and monitoring charitable activities, there is no private right of action available against officers and directors to ensure accountability. The charity's board is required to fill this void, by ensuring that the organization acts in accordance with its mission through meaningful oversight of operations and policy guidance in a way that assures integrity and effective management but without leading to board involvement in the organization's day-to-day activities.

The basic duties of directors of charities and for-profit organizations are virtually the same; this is the case even though the organizations are governed by different laws and have different constituent relations. Directors of charities are required to discharge their duties in accordance with the following basic fiduciary duties:

- ***Duty of care*** – act in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances;

- ***Duty of loyalty*** – act in good faith in a manner the director reasonably believes to be in the best interests of the organization; and

- ***Duty of obedience*** **–** act within the organization's purposes and ensure that the mission is pursued.

Breaches of fiduciary duty are enforced by the Attorney General – this is because charitable beneficiaries generally lack standing to bring private actions. (In contrast, directors of for-profit organizations owe fiduciary duties to shareholders who can bring actions for breach of those duties.) However, these duties are also articulated in the IRS guidelines for "good governance" and on audit, the IRS will request documentation to show that these duties have been met. Enforcement actions can result in significant personal liability for directors.

A. The Duty Of Care and the Business Judgment Rule

The standard of conduct applied in measuring a director's duty of care is similar to the standard applied to directors of for-profit business corporations. Broadly stated, a director can fail to discharge his or her duty of care in two ways: by failing to properly manage or supervise the corporate entity (the "duty of attention") or, so long as the director is disinterested, independent and acting in good faith, by failing to make an informed decision about an important transaction or fundamental change in the way the corporate entity operates (the "duty of informed decision-making").

(1) Duty of Attention.

Essentially, the duty of attention requires the director to actively participate in the oversight of the corporate entity's activities and operations. See Hansen, The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project, 48 Bus. Law. 1355, 1359-60 (in business corporation context, directors' liability for "non-decision making" generally founded on express abandonment of duty and patterns of exacerbated neglect amounting to abandonment of duty). Elements of such active participation are:

- regular attendance at board and committee meetings, with a written record of any absences;
- careful review of meeting minutes, and notation to the corporation's secretary of any errors or misinterpretations of what had been said at a meeting;
- careful review of any written materials disseminated to directors prior to or at meetings;
- regular monitoring of any activities delegated to standing or special committees (including review of committee meeting minutes);
- periodic meetings with or visits to management personnel and other employees to question them and inquire about aspects of the corporate entity's activities within their purview;
- access to and the opportunity to ask questions of outside experts (accountants, lawyers, investment advisors);

- access to and review of corporate books and records;
- careful review of any financial statements or reports prepared for the corporation, including any analysis or discussion by management;
- formation of committees (e.g., quality assurance, credential, finance, personnel, facilities) to apply specific expertise of board members to areas most in need to close oversight;
- a requirement that any management or outside expert's reports be formally presented to and accepted by a board;
- familiarity with the charter or certificate of incorporation and by-laws of the corporate entity;
- familiarity with corporate policies affecting senior management and directors;
- familiarity with provisions made by the corporation to indemnify and/or insure its directors and officers; and
- general knowledge of constitutional and statutory law which affect the corporation.

(2) Duty of Informed Decision-Making.

In the context of charties, practical elements of informed decision-making would include the following:

- the opportunity to hear a detailed presentation by management, accompanied by written materials if appropriate, explaining the rationale for the proposed decision and why management is making the recommendation it has;
- the opportunity to hear the advice and recommendation of a recognized outside expert, including legal counsel, on the subject;
- the opportunity to debate and deliberate on the proposal at a Board level and if possible to allow a period of several days or weeks for reflection and further consideration before requiring a vote;
- where appropriate, the gathering of information from comparable institutions about how they had dealt with similar situations; and
- the opportunity to request any additional information deemed relevant by a director from management or outside experts, including legal counsel, and time for the directors to consider such additional information.

(3) Careful Delegation of Management and Oversight Responsibilities.

Although a board is expected to delegate certain management responsibilities, and is entitled to rely on reports and other information prepared or presented by committees of a Board, officers and employees, or outside experts, such delegation must be done in a clear fashion to qualified delegates and with a critical eye to the reliability and competence of the reports and the delegates. Some matters cannot be delegated, and directors should consult state statute to confirm these limitations. Even when authority is delegated, those directors and officers acting on behalf of a Board are still subject to the duty of care.

(4) The Business Judgment Rule.

The assumption of the Business Judgment Rule is that there is no objective standard by which to evaluate the correctness of corporate business decisions and courts are ill-equipped to make such evaluations. If directors are free of conflicts of interest and have used due care, their decisions will not be questioned, even though those decisions may turn out with hindsight to have been unwise. The key concept is the disinterested, good faith exercise of "procedural due care." This generally involves:

- being provided sufficient information (both written and oral); and
- having adequate opportunity and time to consider, discuss and act on it.

The Business Judgment Rule, however, does not apply to all areas of a director's potential liability. For example, it does not shield directors from liability for decisions, actions or the lack thereof which violate specific laws (e.g., tax or environmental laws) or from claims not based on a director's duty to the corporation (e.g., discrimination or defamation).

B. The Duty Of Loyalty

The duty of loyalty requires the director to act in a manner that does not harm the organization. It further requires the director to avoid using his or her position to obtain improperly a benefit for himself or herself, or an advantage which properly belongs to the corporation. See, e.g., Fitzgerald v. National Rifle Association of America, 383 F. Supp. 162 (D.N.J. 1974) (directors breached fiduciary duty by denying a directoral candidate an opportunity to advertise in The American Rifleman magazine and thereby using corporate instrumentality to perpetrate themselves in office). The fact that the transaction is one in which the director has a personal interest is usually less significant than whether it was fair to the corporation at the time the decision was made and whether the decision was reached in an impartial board environment. The clear exception is for self-dealing by private foundations under Internal Revenue Code § 4941.

(1) A Director Must Place the Interests of the Corporation Ahead of Personal Gain.

A director is expected to make decisions objectively, to refrain from participation, and to obtain approval from the corporation where there is a relationship which impairs the director's objectivity. American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 5.02 (1993). In a conflict of interest situation, the director might receive returns more favorable than he or she would otherwise gain in an open market.

A conflict of interest is present whenever a director has a material interest in a transaction to which the corporation may be a party. See ABA, Guidebook for Directors of Nonprofit Corporations 28 (1994). Conflicts can occur either directly or indirectly, whether through personal involvement, a family relationship or an employment or investment relationship.

The conflict may involve: use of corporation's property or funds; transactions with corporation that unfairly favor the director; usurping corporate opportunities; or competing with the corporation.

(2) The Prevalence of Conflicts.

Conflicts of interest, divided loyalties, and transactions among directors, officers and their corporations abound in the charitable sector. Breaches of loyalty are not only much easier to identify than breaches of care, they are more prevalent. In many situations, interested transactions are a healthy necessity.

- They may provide access to resources unavailable from the marketplace.
- The financial status of the organization may be so poor that market sources of credit, supplies or services are unattainable.
- A loan of money, goods or services may be obtainable only from a director, an individual concerned with the organization's welfare.

In other situations, the interested transaction may be unethical or illegal and, therefore, violate the director's duty of loyalty to the corporation and to the public. See, e.g., Scheuer Family Foundation v. 61 Assocs., 179 A.D. 65, 582 N.Y.S.2d 662 (App. Div. 1992) (defendant-directors of foundation had an interest in the foundation's investment advisor and asset manager, which allegedly mismanaged the foundation's assets, including by investing in publicly traded securities issued by a corporation in which the defendants were officers).

In analyzing conflicts of interest, it is necessary to focus upon both the procedural aspects of the transaction and upon its substantive nature. The procedural aspects of the transaction relate to the process by which the transaction is approved for the corporation by a board of directors. The procedural inquiries include:

- whether corporate procedures for interested transactions have been established and whether they were followed in the particular transaction;
- whether a board environment was impartial and objective at the time the decision was made;

- whether the information relating to the transaction was fully disclosed by the interested director to the relevant decision makers; and

- whether the interest of the director was disclosed to the relevant decision makers.

Substantive factors in conflict of interest transactions involve:

- the fairness of the transaction to the corporation in terms of what the corporation received;

- the frequency of interested transactions between directors and the organization (along with corresponding inurement concerns under the tax laws); and

- the overall financial status of the organization in relation to the transaction.

Whether an interested transaction should be permitted or not depends greatly on its facts and circumstances and the director's motivations for entering the transaction. A type of transaction which may be perfectly proper in one context may be inappropriate under slightly different circumstances.

Within the context for charities, conflicts of interest must also be addressed within the context of Code Section 4958 which is discussed in more detail below.

C. Duty Of Obedience

Unlike the Board duties described above, the duty of obedience is generally not statutorily based. Rather, it is the result of court decisions. Generally, the duty of obedience, requires board members to "be faithful to the purposes and goals of the corporation as unlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d'etre of the organization." Thus, the duty of obedience mandates that a board not only seek to carry out the charitable purposes of the organization as stated in its certificate of incorporation, but also that it guard and seek to preserve that original mission as well.

II. INTERMEDIATE SANCTIONS AND THE REBUTTABLE PRESUMPTION

A. The Bottom Line for Board Members

Members of governing boards of charitable organizations described in Internal Revenue Code Section 501(c)(3) have a duty to assure that the organization does not provide certain inside parties (i.e., directors and officers) more than an arm's length, fair market value compensation, contract terms and/or fringe benefits. The IRS imposes severe penalties on the recipient of excessive compensation, and also imposes personal financial penalties on directors or trustees when it finds an "excess benefit" transaction.

Any paid contracts, salary or benefit adjustments or bonus decisions may expose a board to these penalties. Therefore, a board will want to consider steps to assure that the compensation and benefit levels for insiders are well within allowable ranges and contain no excess benefits. By having a board follow certain procedures in setting any insider compensation and approving the contract, it can largely eliminate a board members' personal penalty exposure.

B. Intermediate Sanctions – Overview

Excise taxes are imposed on certain "disqualified persons" who improperly benefit from an "excess benefit transaction" involving the organization. Excise taxes are also imposed on "organization managers" who participate in an excess benefit transaction knowing that it is such a transaction, unless the participation is not willful and is due to reasonable cause.

These penalties are commonly referred to as "intermediate sanctions." Before these provisions became effective in 1995, the IRS's only tool when it encountered excess benefit transactions was to revoke the tax exempt status of a Code Section 501(c)(3) organization. It had no available sanction other than what was considered to be tantamount to the "death penalty" for a charity. The scandal involving the compensation and benefits of William Aramony, President of United Way of America, and the unwillingness of the IRS to revoke United Way's exempt status because of the Aramony transactions, persuaded Congress that intermediate sanctions were needed. Accordingly, it enacted what is now Code Section 4958, entitled "Taxes On Excess Benefit Transactions."

C. Taxes on Disqualified Persons

An initial tax is imposed, for each excess benefit transaction, on the disqualified persons. The tax is equal to 25% of the "excess benefit" from the transaction. An additional tax is imposed in any case in which an initial 25% tax is imposed and the excess benefit involved in the transaction is not corrected within the correction period. The additional tax is equal to 200% of the excess benefit involved.

(1) Who are Disqualified Persons?

A "***disqualified person***", with respect to any transaction, is any person who was in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the excess benefit transaction. A disqualified person would include, among others, any of the following:

- any board member;
- any person who, regardless of title, has ultimate responsibility for implementing the decisions of a board or for supervising the management, administration, or operation of the organization, such as the organization's president, chief executive officer (CEO), or chief operating officer (COO);
- any person who, regardless of title, has ultimate responsibility for managing the organization's finances, such as the organization's treasurer or chief financial officer (CFO);
- any other person in a position to exercise substantial influence during the applicable period, unless such person is an employee of the organization who:

- receives economic benefits from the organization of less than \$90,000;
  - is not defined in 1, 2 or 3 above; and
  - is not a substantial contributor to the organization.
- any member of the family of a person who is a disqualified person; and
- any entity in which a disqualified person holds a 35% or greater interest.

(2) What is an Excess Benefit Transaction?

An "***excess benefit transaction***" is any transaction in which an economic benefit is provided by the organization directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) that the organization received for providing the benefit. An "***excess benefit***" is the excess referred to in the above definition of excess benefit transaction. The most common form of an excess benefit transaction occurs when an organization pays a disqualified person unreasonable compensation with respect to the services rendered.

Compensation is reasonable if it is in an amount that would ordinarily be paid for like services by like enterprises under similar circumstances. With respect to excess or unreasonable compensation, the most critical concept is that all of the consideration for performance of services given to an individual needs to be included in determining whether the compensation is reasonable. Compensation includes all forms of cash and non-cash compensation, including salary, fees, bonuses, and severance payments. Compensation includes all other compensatory benefits, whether or not included in gross income for income tax purposes, including payments to welfare benefit plans, such as plans providing medical, dental, life insurance, severance pay, and disability benefits, and most taxable and nontaxable fringe benefits.

(3) Rebuttable Presumption of Reasonableness – Fixed Payment Arrangements

If the following three conditions are satisfied, all payments under a fixed-payment compensation arrangement between the organization and a disqualified person are presumed to be reasonable:

- the compensation arrangement must be approved in advance by a board composed entirely of individuals who do not have a "conflict of interest" with respect to the compensation arrangement;
- a board must obtain and rely upon "appropriate data as to comparability" of compensation before making its determination; and
- a board must "adequately document" the basis for its determination concurrently with making that determination.

If the above three requirements are satisfied, then the Internal Revenue Service may rebut the presumption that so arises only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by a board.

A board member will not have a "***conflict of interest***" with respect to a compensation arrangement if such member:

- is neither a disqualified person economically benefiting from the compensation arrangement, nor is a member of the family of the disqualified person;
- is not in an employment relationship subject to the direction or control of any disqualified person economically benefiting from the compensation arrangement;
- does not receive compensation or other payments subject to approval by any disqualified person economically benefiting from the compensation arrangement;
- has no material financial interest affected by the compensation arrangement; and
- does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement where that disqualified person in turn has approved or will approve a transaction providing economic benefits to the member.

A board has "***appropriate data as to comparability***" if, given the knowledge and expertise of its members, it has information sufficient to determine whether the compensation arrangement in its entirety is reasonable. Relevant information as to comparability of compensation includes (but is not limited to):

- compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions;
- the availability of similar services in the organization's geographic area;
- current compensation surveys compiled by independent firms; and
- actual written offers from similar institutions competing for the services of the disqualified person.

There is a safe harbor for reviewing compensation arrangements available to small tax-exempt organizations, defined here as those with annual gross receipts (including contributions) of less than $1 million. Under this safe harbor, a board of a smaller organization will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. Although an organization's budget may be too large to be eligible for this exception, it is important to note the implication that larger organizations such as the organization would logically be expected to obtain data from ***more than*** three comparable organizations to qualify for the rebuttable presumption.

Written or electronic records of a board approving the compensation arrangement must note all of the following for a decision to be "***documented adequately***":

- the terms of the compensation arrangement that was approved and the date it was approved;
- the members of a board who were present during the debate on the transaction that was approved and those who voted on it;
- the comparability data obtained and relied upon by a board and how the data was obtained;
- any actions taken with respect to consideration of the transaction by anyone who is a member of a board but who had a conflict of interest with respect to the transaction; and
- if a board determines that reasonable compensation is higher or lower than the range of comparability data obtained, a board must record the basis for its determination.

(4) Rebuttable Presumption of Reasonableness – Non-Fixed Payment Arrangements

The rebuttable presumption of reasonableness arises, in the case of a payment that is not a fixed payment:

- only after the exact amount of the payment is determined, or
- a fixed formula for calculating the payment is specified, and
- the three requirements for the presumption are satisfied after that determination.

There is, however, a limited exception available for certain non-fixed payments subject to a cap. If a board approves an employment contract with a disqualified person that includes a non-fixed payment – such as a discretionary bonus – subject to a specified cap, a board may establish a rebuttable presumption with respect to the non-fixed payment at the time the employment contract is entered into if:

- before approving the contract, a board obtains appropriate comparability data indicating that a fixed payment of up to a certain amount to the particular disqualified person would represent reasonable compensation;
- the maximum amount payable under the contract, taking into account both fixed and non-fixed payments, does not exceed the amount referred to immediately above; and
- the other two requirements for the rebuttable presumption of reasonableness are satisfied.

D. Taxes on Organization Managers

In cases where an initial 25% tax has been imposed on disqualified persons, a tax is also imposed with respect to an excess benefit transaction on the organization managers who "participate" in the transaction "knowing" it to be an excess benefit transaction. The tax is equal to 10% of the excess benefit. However, the tax is not imposed where the organization manager's participation was not "willful" and was due to "reasonable cause."

(1) Who is an Organization Manager?

An "***organization manager***" is:

- any officer, director, or trustee of the organization; or
- any individual having powers similar to those of officers, directors or trustees of the organization, regardless of the individual's title.

Under a special rule for certain committee members, an individual who is not an officer, director, or trustee, yet serves on a committee of a board that is attempting to invoke the rebuttable presumption of reasonableness based on the committee's actions, is an organization manager for purposes of the 10% tax imposed on organization managers.

(2) What is Knowing Willful Participation?

"***Participation***" includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act, as well as any affirmative action by the manager. However, a manager is not considered to have participated in an excess benefit transaction where the manager has opposed the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the organization.

An organization manager participates in a transaction "***knowingly***" only if the person:

- has actual knowledge of sufficient facts so that, based solely upon those facts, the transaction would be an excess benefit transaction;
- is aware that such an act under these circumstances may violate the intermediate sanction provisions; and
- negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.

"Knowing" does not mean having reason to know. However, evidence tending to show that a manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of the fact or rule.

Participation by an organization manager is "***willful***" if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by an organization manager is not willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.

(3) What is Reasonable Cause?

The participation by an organization manager is "***due to reasonable cause***" if the manager has exercised his responsibility on behalf of the organization with ordinary business care and prudence.

(4) Safe Harbor – Reliance on Professional Advice

There is a safe harbor under which participation by an organization manager in a transaction will ordinarily not be subject to the 10% tax, even though the transaction is later held to be an excess benefit transaction. Specifically, an organization manager is ordinarily not considered to have knowingly participated in a transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional regarding the elements of the transaction within the professional's expertise. However, the absence of a written opinion of an appropriate professional regarding the elements of a transaction does not, by itself, give rise to any inference that an organization manager knowingly participated in the transaction.

Appropriate professionals, on whose written opinion an organization manager may rely, are limited to:

- legal counsel, including in-house counsel;
- certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and
- independent valuation experts who:
  - hold themselves out to the public as appraisers or compensation consultants;
  - perform the relevant valuations on a regular basis;
  - are qualified to make valuations of the type of property or services involved; and
  - include in the written opinion a certificate that the above requirements are met.

A written opinion is reasoned even though it reaches a conclusion that is later determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. However, a written opinion is not reasoned if it does nothing more than recite the facts of the transaction and express a conclusion.

(5) Safe Harbor – Reliance on the Rebuttable Presumption of Reasonableness

Under this safe harbor, an organization manager is ordinarily not considered to have "knowingly" participated in a transaction, even though the transaction is later held to be an excess transaction, if the appropriate authorized body has met the requirements of the rebuttable presumption of reasonableness with respect to the transaction.

(6) Liability of Organization Managers

Any organization manager who participated in the excess benefit transaction must pay the 10% tax. All managers liable for the 10% tax with respect to an excess benefit transaction are jointly and severally liable for it. If an organization manager also receives an excess benefit from an excess benefit transaction, the manager may be liable for both the 10% tax <u>and</u> the 25% tax. For any one excess benefit transaction, the maximum amount of tax imposed the organization managers may not exceed $20,000.

III. BASIC FUNCTIONS OF A BOARD

The board of a charity is responsible for directing the affairs of the organization in accordance with its mission. In practice, the board delegates responsibility for managing the day-to-day activities of the organization to managers; however, fiduciary duties cannot be delegated and, therefore, the board retains oversight responsibility for matters that have been delegated. Board service can no longer be viewed as just an honor – the oversight responsibilities of directors are real.

The primary functions of the board typically include the following:

- Selecting, monitoring, evaluating, compensating and – if necessary – replacing the CEO;

- Defining and reevaluating from time-to-time the long-term strategy by which the organization fulfills its mission, and monitoring the performance of the organization in implementing the strategy;

- Approving budgets and financial plans; reviewing and approving material capital allocations and expenditures; monitoring and ensuring the integrity of the organization's financial reporting processes, internal control systems and audit; hiring the independent auditor (if any) and assuring itself of the auditor's lack of significant relationships that might impair objectivity;

- Balancing constituency interests in a manner that is consistent with the mission;

- Ensuring compliance with all applicable laws, regulations, policies and ethical standards of the organization (including laws and regulations enforced by the Internal Revenue Service, as well as the organization's conflict of interest policy, code of conduct and ethics, whistleblower policy and document retention policy); and

- Assisting in obtaining resources through making personally meaningful financial contributions, fundraising and/or grant-writing.

The demands of board service are heavy – board responsibilities are wide-ranging and board service is part-time (and usually voluntary). The board should consider implementing board processes and structures that can assist directors to more efficiently and effectively fulfill these responsibilities; however, in doing so, the board should bear in mind that board practices should address the unique needs and circumstances of the particular organization – one size does not fit all.

The board should look for governance "best practices" that embody pragmatic solutions that will work given the particular needs and circumstances of the organization, including organizational structure, size, activities, life-cycle stage and funding mechanisms.

The goal of "best practice" is to promote active oversight and objective and informed judgment by the board. The critical issue of board governance, applicable to both for-profit and tax-exempt organizations, is ensuring that the board serves as an active and independent mechanism of oversight as to the activities of the managers to whom the board has delegated authority. This is necessary to promote the accountable functioning of the organization, including the use of assets that have been entrusted to the organization by others. Board effectiveness can be enhanced by considering the following guiding principles that are common to each board.

IV. COMMON GUIDING PRINCIPLES FOR EFFECTIVE BOARDS

A. Stated Goals

Effective governance requires that goals are clearly stated. Board accountability begins with the charitable, educational or social mission of the organization. The mission is the reason why the organization exists and has been granted favored status as a charity by the IRS. The mission should be the organization's "polestar" in that it provides a measure of success and guides the organization's conduct. (This can be compared to the for-profit world "polestar" of maximizing shareholder value through the efficient production of goods and services.)

The board is charged with ensuring that managers further the mission, without wasting assets or engaging in self-dealing. Therefore, as a starting point, the board needs to:

- understand the entity's mission, as stated in its governing documents;
- develop with management a strategy for carrying out that mission; and
- monitor and assess management's efforts to carry out that strategy in line with the mission.

B. Clear Delineation of Responsibility and Authority and the Line Between Oversight and Management

All directors need to understand the role of the board as an entity, as well as their individual duties as fiduciaries and the distinct role of management. The role of the board is one of oversight – directors "direct" – while the role of management is to carry out the day-to-day activities of the organization – managers "manage." Often members of a board cross the line between oversight and management by becoming overly engaged in the operating activities of the entity, such as the day-to-day work required to fulfill programmatic goals. Board involvement in operating activities can lead to tensions between the board and management/staff. Boards should consider the extent to which their involvement in operating – as opposed to strategic – activities benefits or hinders the ability of management to perform.

The board may wish to consider discussing and defining the respective roles of the board and management with respect to strategic and operational activities in a formal "delegation of authority" that addresses the specific matters reserved to the CEO and those reserved to the board. For example, the board typically delegates the execution of policies and strategic objectives to management. Creating a formal delegation of authority can also help the board identify and communicate expectations about what issues are worthy of board consideration and in what time frame decisions are expected to be made.

C. Monitoring and Measuring Performance

Active board oversight requires that management performance be evaluated against the specific operational goals that the board has determined will further the agreed strategy in line with the organization's mission. The board should then define with management the specific benchmarks (both long-term and short-term) that would indicate successful performance and monitor results achieved by management against those benchmarks. If performance goals are not being met, the board should consider where adjustment may be necessary; for example, improve performance, adjust the strategy and replace management where necessary. Management changes are inevitable and the board should ensure that a succession plan for key executives is in place.

The board should utilize its evaluation of management performance in designing and implementing an executive compensation scheme that will compensate executives fairly and includes appropriate incentives for performance. It may also be appropriate to compensate directors for their contribution to the organization.

D. "Following the Money"

Overseeing the finances of the organization is a critical part of the board's role. Fulfilling this oversight responsibility begins with ensuring that the organization has an effective Chief Financial Officer or equivalent (such as a bookkeeper or outside accounting firm); recruiting such a person can be challenging, particularly as salaries are generally lower than in the for-profit sector. The board should establish open lines of communication with the CFO to facilitate the exchange of information. The board should work with the CFO in developing and approving budgets and financial plans, and should test management assumptions that may be embedded within budgetary analysis. The board is also responsible for monitoring and ensuring the integrity of the organization's financial reporting processes (including recordkeeping), internal control systems and audit, and should hire the independent auditor (if any) after assuring itself of the auditor's lack of significant relationships that might impair objectivity.

E. Determining Board Focus & Information Needs

The board's ability to govern effectively depends on how it focuses its time and attention and the information it has available to it. The board should take charge of its own agenda by identifying, articulating, prioritizing and scheduling the issues that the board will address. Usually, board attention – and therefore the board's agenda – is best focused on "following the money," setting strategic direction and long-term goals, monitoring management's progress and results to achieve those goals, and ensuring satisfactory compliance with ethical standards and the law.

Board meetings should be structured to make the best use of board time. Meetings should be scheduled well in advance – for example, via an annualized schedule to address foreseeable issues – with additional meetings called when board review with respect to other issues is required. The bulk of the board's meeting time should be reserved for discussion of the issues it considers to be most important; these issues should be dealt with before administrative and housekeeping-type matters are addressed. Management presentations at meetings should be kept to a minimum, as most of this information should be capable of being transferred to the board for its consideration in advance of the meeting.

An effective board requires accurate, relevant and timely information relating to the organization and the context in which it operates to enable it to fulfill its role. The board should identify what information it needs and work with management to ensure that it obtains such information. Information should be distributed in advance of meetings to enable directors to review the material and reflect on it.

F. Board Size and Composition

Size and composition influence the ability of a board to be effective. Most decision-making groups function best with between seven and ten members. Boards are often much larger, due to their fund-raising nature. For a very large board, if downsizing is not practical, the board may wish to consider whether there are ways to facilitate efficient decision-making through the use of committees; for example, some very large boards create an executive committee or advisory board that has authority to make decisions on behalf of the board where appropriate.

Board candidates should be selected with a set of criteria in mind that are specific to the needs of the particular organization. The board should reflect, as far as possible, an appropriate balance of independence, sound judgment, business specialization, technical skills, diversity, fundraising ability and/or willingness to make personally meaningful gifts, geographic representation and other desired qualities.

The board should be comprised of directors who are committed to the organization’s mission. Directors should ensure that they are interested in and understand the activities of the organization, the environment in which it exists and the risks facing it. They should learn about the structure of the organization by reviewing its governing documents, policies and minutes of board and committee meetings from the past year, as well as any literature produced as part of the organization’s programs. Directors should seek out information from management where required to gain this understanding.

G. Board Independence

Independence is the foundation for objective judgment. The board should be comprised and organized in a manner that encourages directors to be engaged and to form and express objective judgments about issues involving inherent conflicts with management such as:

- evaluation of management performance, compensation and succession planning;
- oversight of audit, accounting and financial reporting; and
- determination of board composition and governance processes.

The board should include a number of persons who lack material business relationships to the entity and also lack material business and family relationships to senior management and key constituents.

H. Board Leadership

The leadership of any organization is critical and board leadership is especially so. An effective board leader is highly engaged, independent, capable of developing a strong working relationship with management and in guiding the board to consensus after free and open discussion of viewpoints. An independent board leader is especially important for:

- organizing the board agenda with input from management and helping to identify the board's information needs;
- leading board discussions of management performance and compensation in sessions at which management is not present ("executive session"); and
- encouraging frank but collegial discussions both at the board level and as between the board and management.

The board should not be led by management, either in name or in spirit.

I. Policies and Guidelines

The board plays a key role in setting the tone of the organization. It sets the tone through establishing policies and guidelines that set forth expectations for behavior within the organization and by assessing whether senior management is promoting an appropriate ethical culture within the organization. These policies could include the following:

- ***Board guidelines*** that set forth expectations of directors, which may include board functions, processes and structures, as well as requirements to make personally meaningful gifts and/or contribute to fundraising efforts;
- ***Ethics and business conduct codes*** applicable to the board, management and employees requiring fulfillment of responsibilities in a manner that furthers the mission of the organization and complies with law, regulations, ethical standards and policies adopted by the organization;
- ***"Whistleblowing" procedures*** to receive, investigate and take appropriate action regarding fraud or non-compliance with law or organizational policy, and to protect "whistleblowers" against retaliation; and
- ***Document retention policies*** to ensure that documents are retained pursuant to applicable laws and that documents that may be relevant to legal proceedings or governmental investigations are not.

The board sets the tone for the entire organization; it does so best by adopting a governing style that emphasizes:

- strategic leadership rather than a focus on administrative detail;
- focus on the future rather than on the past;

- anticipation and preparedness rather than reactivity;
- collegiality, with respect for diverse viewpoints, and not divisive;
- consensus building, not "majority rule;" and
- conflict avoiding (and disclosing).

J. Committee Structure & Operations

Appropriate structure and use of board committees can enhance the efficiency and effectiveness of the board. Board committees may be particularly useful with respect to board responsibilities that require independent judgment and that may involve a conflict of interest for management; such committees should – where possible – be comprised of directors who are independent from management and should be provided for in the organization's bylaws. Key board committees include:

- ***Audit committee*** – responsible for hiring and assuring the independence of the independent auditor (if any), and providing oversight of internal controls and related processes designed to assure the reliability of financial data;
- ***Compensation committee*** **–** responsible for determining and reviewing the compensation of the CEO and other senior managers in accordance with objective, documented and comparable information, and for ensuring that compensation is tied to the achievement of predetermined performance goals that are keyed to mission-related accomplishments rather than financial results; and
- ***Nominating and governance committee*** **–** responsible for nominating board candidates, ensuring that the size, leadership and composition of the board are appropriate, and overseeing governance structures and policies (including committee structure, conflicts of interest policies and bylaws).

The 2005 National Association of Corporate Directors Not-For-Profit Governance Survey[1] indicates that these key board committees are prevalent in not-for-profit organizations identified as "leading" based on size and established reputations:

Standing Committee	Prevalence	Fully Independent?
Audit	96.2%	92.0%
Compensation	75.0%	89.5%
Nominating/Governance	80.8%	75.6%

[1] National Association of Corporate Directors (NACD), *2005 NACD Not-For-Profit Governance Survey* (2006) 19. The NACD surveyed more than 200 non-for-profit organizations identified as "leading" based on their size and established reputations and received 52 responses.

However, whether or not an would find it useful to establish a particular committee will depend on the needs and circumstances of the organization. For example, an organization with significant financial resources or complex financial arrangements may benefit significantly by establishing an audit committee. In contrast, a small organization with simple financial structures may decide that it would be efficient and effective to entrust responsibility for ensuring the integrity of financial reporting to the entire board. (In either case, some members of the board should be financially literate and at least one director should be sophisticated concerning financial reporting and accounting.)

Committee charters often help set forth the responsibilities of each committee and clarify whether decisional authority is delegated to the committee or whether the committee is to undertake the background work and make recommendations to the board for board approval.

As discussed above, organizations with large boards may find it useful to organize an executive committee to take on a number of tasks that might otherwise fall to the full board, but can be achieved more efficiently in a smaller group. The boards often have a large number of committees that focus on operational or program aspects; for example, strategic planning, finance, fundraising and public relations. Care should be taken that these committees do not result in the board becoming over-engaged in operational matters and unduly hampering managements' ability to perform effectively.

K. Board Health and Evaluation

The board should regularly evaluate its performance and seek to continually improve. The board may wish to consider evaluating its effectiveness against BoardSource's "Twelve Principles of Governance that Power Exceptional Boards:"[2]

1.	**Constructive Partnership**	Exceptional boards govern in constructive partnership with the chief executive, recognizing that the effectiveness of the board and chief executive are interdependent.
2.	**Mission Driven**	Exceptional boards shape and uphold the mission, articulate a compelling vision, and ensure the congruence between decisions and core values.
3.	**Strategic Thinking**	Exceptional boards allocate time to what matters most and continuously engage in strategic thinking to hone the organization's direction.
4.	**Culture of Inquiry**	Exceptional boards institutionalize a culture of inquiry, mutual respect, and constructive debate that leads to sound and shared decision making.

[2] BoardSource, *The Source*: *Twelve Principles of Governance That Power Exceptional Board* (2005).

5.	**Independent-mindedness**	Exceptional boards are independent-minded. When making decisions, board members put the interests of the organization above all else.
6.	**Ethos of Transparency**	Exceptional boards promote an ethos of transparency by ensuring that donors, stakeholders, and interested members of the public have access to appropriate and accurate information regarding finances, operations, and results.
7.	**Compliance with Integrity**	Exceptional boards promote strong ethical values and disciplined compliance by establishing appropriate mechanisms for active oversight.
8.	**Sustaining Resources**	Exceptional boards link bold visions and ambitious plans to financial support, expertise, and networks of influence.
9.	**Results-Oriented**	Exceptional boards are results-oriented. They measure the organization's advancement towards mission and evaluate the performance of major programs and services.
10.	**Intentional Board Practices**	Exceptional boards intentionally structure themselves to fulfill essential governance duties and to support organizational priorities.
11.	**Continuous Learning**	Exceptional boards embrace the qualities of a continuous learning organization, evaluating their own performance and assessing the value they add to the organization.
12.	**Revitalization**	Exceptional boards energize themselves through planned turnover, thoughtful recruitment, and inclusiveness.

L. IRS Guidelines for "Good Governance"

While the Code does not have specific requirements with respect to governance requirements, the IRS takes the position that without "good governance" a tax-exempt organization cannot operate consistently with Code Section 501(c)(3). Some governance areas that the IRS may review on audit include the following (many of these have already been noted above):

1. Executive compensation. A charity may not pay more than reasonable compensation for services rendered. According to the IRS, compensation payments are reasonable if the compensation arrangement is approved in advance by an authorized body composed entirely of individuals who do not have a conflict of interest with respect to the arrangement, the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, and the authorized body adequately documented the basis for its determination concurrently with making the determination. See discussion regarding Code Section 4958 above.

2. Conflicts of interest. The charity directors owe it a duty of loyalty. The duty of loyalty requires a director to act in the interest of the charity rather than in the personal interest of the director or some other person or organization. Specifically, the duty of loyalty requires a director to avoid conflicts of interest that are detrimental to the charity.

Many charities have adopted a written conflict of interest policy to address potential conflicts of interest involving their directors, trustees, officers, and other employees. The IRS encourages a charity's board of directors to adopt and regularly evaluate a written conflict of interest policy that requires directors and staff to act solely in the interests of the charity without regard for personal interests. The IRS encourages organizations to require its directors, trustees, officers and others covered by the policy to disclose, in writing, on a periodic basis any known financial interest that the individual, or a member of the individual's family, has in any business entity that transacts business with the charity. The organization should regularly and consistently monitor and enforce compliance with the conflict of interest policy. Organizations that file Form 990 will find that Part VI, Section B, Line 12 asks whether an organization has a written conflict of interest policy, and whether it regularly and consistently monitors and enforces compliance with the policy.

3. Investments. State law or organizational documents may require the organization's governing body or certain other persons to oversee or approve major investments. The IRS encourages charities that make such investments to adopt written policies and procedures requiring the charity to evaluate its participation in these investments and to take steps to safeguard the organization's assets and exempt. Organizations that file Form 990 will find that Part VI, Section B, Line 16 asks whether an organization has adopted procedures and policies regarding participation in a joint venture or similar arrangement with a taxable entity. In addition, Form 990, Schedule D, asks detailed information about certain investments.

4. Fundraising. The IRS encourages charities to adopt and monitor policies to ensure that fundraising solicitations meet federal and state law requirements and solicitation materials are accurate, truthful, and candid. Charities are encouraged to keep their fundraising costs reasonable and to provide information about fundraising costs and practices to donors and the public. Organizations that file Form 990 will find that Schedules G and M solicit information about fundraising activities, revenues and expenses.

5. Governing body minutes and records. The IRS encourages the governing bodies and authorized sub-committees to take steps to ensure that minutes of their meetings, and actions taken by written action or outside of meetings, are contemporaneously documented. Organizations that file Form 990 will find that Part VI, Line 8 asks whether an organization contemporaneously documents meetings or written actions undertaken during the year by its governing body and each committee with authority to act on behalf of the governing body.

6. Document retention and destruction. The IRS encourages charities to adopt a written policy establishing standards for document integrity, retention, and destruction. The document retention policy should include guidelines for handling electronic files. The policy should cover backup procedures, archiving of documents, and regular check-ups of the reliability of the system. Organizations that file Form 990 will find that Part VI, Section B, Line 14, asks about whether an organization has a written document retention and destruction policy.

7. Ethics and whistleblower policy. The IRS encourages a charity's board or trustees to consider adopting and regularly evaluating a code of ethics that describes behavior it wants to encourage and behavior it wants to discourage. A code of ethics will serve to communicate and further a strong culture of legal compliance and ethical integrity to all persons associated with the organization.

The IRS encourages the board of directors to adopt an effective policy for handling employee complaints and to establish procedures for employees to report in confidence any suspected financial impropriety or misuse of the charity's resources. This policy is commonly referred to as whistleblower policy. Organizations that file Form 990 will find that Part VI, Section B, Lines 5 and 13 ask whether the organization became aware during the year of a material diversion of its assets, and whether an organization has a written whistleblower policy.

M. Other Sources for Good Governance

Other, private, organizations provide information on "good governance". Some of these organizations also offer a process by which a charity can receive a certification or rating.

- BBB Charity Accountability Program – developed to assist donors in making sound giving decisions and to foster public confidence in charitable organizations. The standards seek to encourage fair and honest solicitation practices, to promote ethical conduct by charitable organization and to advance support of philanthropy. More information is available at **http://www.give.org/for-charities/**

- Charity Navigator – works to guide intelligent giving. By guiding intelligent giving, Charity Navigator aims to advance a more efficient and responsive philanthropic marketplace, in which donors and charities they support work together to overcome the nation's and the world's most persistent challenges. More information is available at **http://www.charitynavigator.org/**

- Guidestar – the most complete source of information about US charities and other nonprofit organizations. Searchable database of more than 1.8 million IRS-recognized organizations. More information is available at **http://www.guidestar.org/Home.aspx**