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COUNSELLORS AT LAW

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NONPROFIT ORGANIZATION REPORT – SUMMER 2013

THE TEN COMMANDMENTS

(OF NONPROFIT GOVERNANCE)

Many years ago we developed and presented an instructional seminar entitled The Ten Commandments of Nonprofit Governance. The content was based on the many nonprofit problems we had handled over the years, and was intended to articulate principles which, if they had been followed, may have prevented the problems or lessened their scope. Our experience in the years since has confirmed the utility of these principles, and we thought they would make for good summertime reading.

I. Never forget the basics. It is impossible to over-emphasize the importance of basic corporate paperwork: staying current with governmental filings, maintaining modern language in the certificate of incorporation and bylaws, and adhering to board meeting formalities (including minutes). The certificate of incorporation and bylaws must recite a mission consistent with your tax exemption, should include language exculpating and indemnifying officers and directors, and should be free of ambiguity and consistent with your governance practices in fact. We have been involved in lawsuits over the years which were the product of ambiguity in corporate documents and/or inconsistency between governance practices and the written text of the documents. Meeting minutes create the official record of your deliberations, and they should be prepared and approved with care because they can be audited by the IRS and state attorneys general, and can be subpoenaed in litigation.

Two recent cases illustrate this principle. The first concerned a Vermont Elks Lodge that forgot to make annual corporate filings with the Secretary of State and had its corporate status administratively revoked, which exposed the members to personal liability for the Lodge's debts. The second involved a Washington State YWCA executive director who alleged that her termination was inconsistent with a bylaw section that required advance notice before she could be fired. A 2006 version required notice and a 2008 version did not. She claimed that the 2008 version had not been adopted in conformance with required corporate formalities such that the 2006 version (requiring notice) was still in effect. The court decided that the 2008 version had been properly adopted by looking at minutes and quorum and voting requirements, and she lost.

II. Make sure your board, management and employees understand their proper roles. The metaphor of a three-legged stool aptly demonstrates that stability is a function of the three components of your organization working in harmony. The first leg is the board of directors, which has ultimate fiduciary responsibility for everything that happens; the second is management, which is responsible for daily operations and is answerable to the board; the third consists of employees who are answerable to management. Each leg should do its job and respect the turf occupied by the others – meaning that the board members should not try to micromanage; management should be transparent with the board and respect its authority; and employees must be left to the supervision of management and should interface with the board only in extraordinary circumstances (such as a whistleblower complaint).

A recent New York case illustrates a violation of this principle. The New York Attorney General ordered board members of nonprofit Educational Housing Services to pay \$1,000,000 in damages to the nonprofit because they let the President negotiate a contract between the nonprofit and a for-profit owned by the President and his wife, under which the for-profit was paid excessive amounts. The board wrongfully delegated all responsibility for confirming the legal propriety of the relationship to the President (even though he was smack in the middle of a conflict of interest) without independently questioning the information (the legal and financial advice) he provided to the board.

III. Adopt and follow a Code of Ethics. In the Fall 2011 edition of this report (*Institutional Integrity and Nonprofit Governance – Time to “Occupy Baltic Avenue?”*)¹ we somewhat facetiously suggested that if everyone followed

¹ All earlier editions of this newsletter are available on our website: www.rrlawpc.com.

Moses' eighth (don't lie) and ninth commandments (don't steal) there would be no need for government regulation or oversight.

The point is that ethics matter – both with respect to internal (among the board, management and employees) and external (with clients, vendors and funders) relationships. Human nature being what it is, there will always be acts of dishonesty and theft. However, it is a prophylactic best practice to memorialize ethical expectations in written form to set a high bar, and to weave ethics into your culture by example. Two poignant cases from our practice include an outside vendor offering golf vacations to a nonprofit executive to have more business steered its way, and an internal program manager who (not for personal gain but to avoid embarrassment) falsified data about the finances of a program she managed. A written code can also be a helpful point of reference if you have to discipline or terminate an employee or a board member, and should contain a whistleblower policy to provide a road map to follow in the appropriate circumstances.

IV. Be a prudent steward of your assets and mitigate your liabilities. When people hear the terms “assets” and “liabilities” they typically think of their financial statements. While your balance sheet is important (see Commandment V), we suggest that readers think of these terms broadly enough to include items which may not be reflected on your balance sheet, but which could affect it negatively in the future.

The principal example of this asset category includes your “goodwill.” In the for-profit sector goodwill is an asset that is monetized (priced) when a business is sold; and in the nonprofit sector it consists of your name, trademark (which you should register), and your reputation – all of which go to your ability to attract grants, donations, clients, board members and employees. The value of your goodwill can be diminished by one bad headline or scandal – such as the Jerry Sandusky sex abuse case at Penn State. Our advice to clients who see a problem of this nature brewing is to quickly get out ahead of it (management should immediately divulge the problem to the board and the board should get legal, insurance and public relations advice) so that you can have some degree of control over how the matter appears in the media or progresses through the legal system (whether criminal or civil).

A risk mitigation technique we highly recommend is the use of controlled affiliated entities (limited liability and title holding companies and supporting foundations) to hold real estate and endowment funds to protect them from lawsuits and claims brought against your operating entities (where risk is highest). It is not that hard or expensive to do this, and the value added could be enormous someday. For more information see the article *Is There a Disregarded Entity in Your Future!* in the Summer 2012 edition of this report.

V. Understand the role of your external auditors. Management and the board should understand the role of outside auditors. First, they should know that there are three levels of diligence that an outside CPA firm can apply to the preparation of your financial statements: a **compilation** (taking *management* supplied data and arranging it in financial statement format without testing or the issuance of an opinion); a **review** (inquiries of *management* and use of analytical procedures to test accuracy and issuance of a limited opinion); and an **audit** (collection of evidence to test *management's* financial disclosures and the issuance of an opinion on the financial statement – which opinion can be “clean” or “qualified”). Audit reports are accompanied by a “management letter” in which the auditors comment on matters related to areas in which management could improve performance.

Readers should (a) understand that funding sources (whether by grant or contract) typically require that an annual audit be performed, and that it is not common in the sector (at least with operating entities) to see compiled or reviewed financial statements; (b) be aware of the term Generally Accepted Accounting Principles (GAAP) which all auditors must follow (prepared by the Financial Accounting Standards Board) to insure consistent industry reporting; and most importantly (c) be cognizant of the fact that the auditor is reviewing the financial data provided by management and offering an opinion on the data for the benefit of the board and outsiders (donors and other funders). As to this third point, the board may need to discipline or remove management if the auditor finds problems, and in any event there should be separate conversations between the board and the auditors (without management in the room) to pose and answer relevant questions.

VI. Create a culture of reasoned transparency. “Transparency” has been infused in the nonprofit *zeitgeist* over the past decade as a necessary element of good governance. In the Summer 2012 edition of this report (*Is Transparency the Best Medicine?*) we suggested that transparency is being oversold by its proponents because privacy also has a very important place on the governance menu. As we said last summer, our conclusion is that translucence is the better prescription. Organizations should let in enough light to assure the public that they are operating lawfully and to maintain positive goodwill (see Commandment IV), while simultaneously recognizing that as to some matters privacy is required by law and the fiduciary duties of directors.

A recent example: a New York court upheld the decision of a nonprofit association to remove a director for inappropriate use of internal information. The board of directors removed its treasurer (Donna) for poor performance, but a board member (Rainer) apparently did not like Donna and took it upon himself to email her employer and the board of another nonprofit she served about her poor performance and removal. When news of Rainer’s actions got back to the association Rainer was hoisted on his own petard and removed from the association for his failure to maintain the confidentiality of the board deliberations about Donna.

VII. Establish governance checks and balances. An analog to Commandment II is the establishment of a system of checks and balances on decisions that may present themselves to management. Statutes and bylaws typically state that the “chief executive” (who may be called CEO, President or Executive Director) has the authority to manage operations in the *ordinary course of business*. In almost all cases a general statement of authority works fine – with the executive aware of when she needs to go to the board or others for approval. For example, it is generally and tacitly understood that the CEO has authority to hire and fire staff, purchase supplies and services, sign office equipment leases, sign checks and the like; and it is also tacitly implied that the CEO must obtain authorization from the board for *out of the ordinary* things such as bank loans, purchases and sales of real estate, expanding service lines, and the like. However, there are often matters that can fall into a “gray area” between the two classes of matters described in the previous sentence. Our recommendation is that nonprofits (based on their size and complexity) give thought to drafting, in bylaws or in a policy statement, guidelines for executive management to follow, such as defining three classes of matters: those completely within the control of the CEO, those that require CEO and another officer’s approval, and a final class that must be approved by the board of directors. The point is to make sure enough “sets of eyes” look at a decision to be sure it is the best one for your organization.

A recent Colorado case illustrates this principle. The President of a condominium association commenced a lawsuit on behalf of the association against the association’s insurance company to recover on a policy. After two years of litigation the insurance company provided evidence (minutes of meetings) that the President had never obtained board authorization to bring the suit, and that under the bylaws the President did not have the authority to cause the suit to be brought in the name of the association. As a result, the Judge threw out the suit, giving the insurance company a major victory.

VIII. Keep your employment handbook current; employment contracts for executives. If you talk with your insurance agent about the type of suits or claims you are most likely to face some day it will not be one involving an automobile accident, fire or slip and fall, but rather one involving a claim from a terminated employee alleging a “wrongful” discharge of some type. It is for this reason that “employment practices” insurance has become commonplace, and why law firms specializing in employment litigation have emerged. Having said this, the fact that insurance is available, and prudent to purchase, does not mean you should not take prophylactic measures to prevent a claim from even being brought.

First and foremost among these measures is maintaining, and following, an up-to-date employment policy handbook. The handbook should articulate all applicable policies (vacation, medical leave, grievance procedures), and should clearly state that employees are “at will” (so that in theory it will be easy to terminate them). All employees should sign a document acknowledging that they have seen and read the handbook. Second, we have come to believe that with executive level employees the best practice is to have a written contract of employment containing a clear

statement of expectations and authority (see Commandment VII) and of salary and benefits – as well as a protocol for termination mid-contract (to mitigate the risk of litigation if things are not working out). We typically draft these contracts with a fixed term of three years or so (with certain extension provisions), so that either side can just let the contract expire if things are not working well.

IX. Obey the law and be a prudent consumer of legal services. While “obeying the law” may seem obvious enough not to need a place on our list, we include it because the law (federal, state and local) has become so complex that it makes even our well-seasoned lawyer brains gyrate and ache. A simple miscue in Medicaid billing, a contract, or a management decision can have devastating legal consequences. We also understand that legal fees are never anyone’s favorite friend.

Some nonprofits may recruit lawyers to the board to obtain free advice, but communications with them as board members are not privileged, and relevant issues may be outside their area of practice. In some cases *pro bono* volunteer services can be obtained, but it is not a practice we follow or recommend except in extraordinary circumstances because it dilutes the professionalism of the relationship. People not being paid for their efforts typically do not bring the same energy, depth of thought or timeliness to the table. How hard is it for you to call your lawyer to complain about her being late or doing an inadequate job if she is not being paid (while still bearing professional risk for the advice given)?

Our recommendation is to negotiate carefully with your lawyers (there is a lot of competition) on matters such as discounted rates, fee caps, fixed retainers and extended payment terms) and to make them a long-term part of a team of trusted advisors so that you stay within the margins of the law at prices you can afford.

X. Continuously assess and improve your performance. We want to conclude with a non-legal topic which has not received the attention it deserves in the nonprofit sector. *Total Quality Management*, *Six-Sigma*, or *Lean Management* are well known process improvement techniques that have been adopted with great success in the industry (the “Toyota Way” is a prime example). These tools require an in-depth analysis of the processes within your organization and the quality of their results, and look at seemingly mundane matters such as the number of hands that touch the paperwork flowing through your staff, reconfiguring office layouts to improve essential communications, or analyzing the routes taken and stops made by your vehicles to improve efficiency and reduce fuel costs. While these techniques are not mission specific, they can produce savings that can be directed to the mission. Space does not permit an in-depth discussion of this topic, but a quick internet search combining a few key words will reveal a substantial amount of literature suggesting that the nonprofit sector is fertile ground for these techniques.

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.

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