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A Financial Times Service

Joining a Nonprofit Board? Learn the Risks

By Tony Chapelle
March 30, 2015

Several of America's major nonprofit organizations are suffering from embarrassing revelations and financial disasters that could adversely affect the public company directors who also serve on their boards.

This month, one of New York City's largest charities, **Federation Employment & Guidance Services** (FEGS), reemerged after it had closed its doors and filed bankruptcy a few weeks earlier. Meanwhile, the **American National Red Cross**, the nation's second-largest nonprofit, has been the subject of media assaults over its integrity for almost a year.

Experts say not enough corporate executives and directors who join nonprofit boards thoroughly check out the charity's financial health and governance in advance. "They do more investigation for publicly held boards because they can read SEC filings, 10-Ks and annual reports," says **Kay Koplovitz**, co-founder of nonprofit venture capital firm **Springboard Enterprises**, which funds women-run tech and life science firms. She and other philanthropy insiders say corporate directors on scandalized nonprofits — especially if they're on investment or finance committees — may expose themselves to personal liability or severely hurt their chances of joining new public boards.

"People would be reluctant to bring someone on a public company board who's on a nonprofit board while it's being identified in the press or while people in board circles are talking about it [in a negative way]," says Koplovitz, who founded cable's **USA Networks** and was its CEO. Now she's a nominating and governance committee member at **Kate Spade** and **CA Technologies**.

"Every public company would choose a scandal-free individual over one with guilt by association," writes attorney **Kit Addleman** in an e-mail. Addleman is the new chair of nonprofit **Girl Scouts of Northeast Texas** as well as a partner at law firm **Haynes and Boone**, where she heads its SEC defense practice.

Top 10 Legal Risks Facing Nonprofit Boards

As set out by Melanie Lockwood Herman of the Nonprofit Risk Management Center and Jeff Tenenbaum and Kristen Sitchler of Venable law firm:

1. Exposures from social media use, misuse and naiveté
2. Unhappy staff and volunteers
3. IRS Form 990 and federal tax-exempt status
4. Copyrights and trademarks
5. Lobbying and political activity compliance
6. Third-party sexual harassment
7. Failure to limit contracting authority and other common mistakes in contracting
8. Lack of synchronicity in board policy and practice
9. Failure to understand and manage conflicts of interest
10. Reliance on the goodwill, good nature and insurance coverage of others

Source: Board Member

A director might even place the corporate board on which they sit at reputational risk. Plaintiff's lawyers are "very aggressive," Addleman explains, in bringing suits for misconduct, conflicts of interest or failure to remain independent before courts in Delaware, where many corporations are registered. "If there is a shadow of concern the work of a director on a nonprofit board [had] a negative impact on the public company, you can bet the plaintiff's attorney will be all over it on behalf of shareholders," she adds.

A public company board would have a fiduciary duty to consider whether a person from a tainted nonprofit brought over any faults that led to the downfall of the problem organization. Second-guessing multiple board decisions could add sizable legal costs and even liability to the board, Addleman says. In extreme cases, the company could face litigation and even government investigation.

Glenn Davis, a governance, risk and compliance consultant and a retired senior partner at accounting firm **CohnReznick**, points out certain risks that are sure to create adverse publicity and damage a not-for-profit's reputation. These include legal and regulatory violations and penalties; major theft, loss or fraud; temporary interruption of an organization's activity; and material errors and omissions in financial reporting. Those types of gaffes could get a group's operating charter revoked and even cause an exodus of donors or loss of government funding, says Davis, who has served as a board member or advisor to more than a dozen nonprofit and public company boards.

In February, the $220 million FEGS shut down due to a $19 million revenue shortfall last year. The *Jewish Daily Forward* cited tax records that disclosed FEGS transferred $30 million over the past three years to a related, for-profit subsidiary it owns. In late March, however, FEGS was rescued by a $10 million loan from another nonprofit, the **UJA-Federation of New York**.

James Tisch, chairman emeritus of FEGS's board, is also CEO and board member of **Loews**. Tisch was formerly chairman of **CNA Financial**, of which Loews owns 90%.

Since last summer, **National Public Radio** and news organization **Pro Publica** have reported that the Red Cross seriously misled the public by claiming 91 cents of every dollar it receives is spent on those in need. The Red Cross has since removed that figure from its website. The news reports prompted New York's state attorney general, **Eric Schneiderman**, and U.S. Sen. **Charles Grassley** (R-Iowa) to conduct investigations and ask Red Cross officials to alter how they disclose the proportion of donations that actually go to humanitarian work.

Red Cross chairman **Douglas Watson** is a board member of health care companies **OraSure Technologies**, **Dendreon**, and **Wright Medical Group**.

Jeff Tenenbaum, chair of the nonprofit organizations practice at law firm **Venable**, says the only difference between corporate boards and nonprofits is that nonprofit directors are seldom compensated. "Everything [else] is equally applicable," he says. He and two other experts have created a list of the top 10 legal risks that nonprofit boards face. For example, nonprofit staff and directors often rely on handshakes rather than written memorandums of agreement or contracts for vendors, partnerships and joint ventures. Boards need to ensure their staff use contracts, the experts say. Also, board members and staffers should be aware of the IRS restrictions that govern their political activities. For example, public charities cannot engage in any campaigning. But they can lobby to a certain extent. Everyone in the organization should be aware of its limits, Tenenbaum and his co-authors say.

Tenenbaum says, however, that there are few cases where nonprofit directors have been held personally liable for breaching their fiduciary duties of care or of loyalty. But he and Addleman advise them to stay well within best practices to be safe.

Avoiding conflicts of interest is one such practice. Addleman writes that while some conflicts are obvious other conflicts might spur more subtle concerns about reputation.
"Not all conflicts are bad," says Tenenbaum. "But the key is to have a process for an independent group of decision makers to look at the conflict and decide what's in the corporation's best interests." Typically that's an audit committee, an ethics committee or an executive committee, he says.

Upon being invited to take a nonprofit board seat, says **Gary Patterson**, a financial coach to corporations, the first place to do research is **Guidestar.org**. This company collects tax returns from nonprofits and runs a database of information on them. Patterson also conducted a survey from nonprofit leaders of the 20 top issues their organizations should talk about but don't.

David Ratcliffe, managing director for national philanthropic solutions at U.S. Trust, **Bank of America**'s wealth management arm, emphasizes a person needs to understand expectations before deciding to join a nonprofit board. Directors may be expected not only to give contributions but to touch their corporate foundation for donations. A financial services executive or director should ask if they're being expected to lend professional expertise. "A lot of financial service corporations don't want their executives sitting on an audit committee. It heightens their risk," Ratcliffe says.

Ratcliffe warns directors to understand any funding sources and accounting problems to avoid being tainted later. Individuals also need to know whether the institution has an endowment. If so, they need to find out the strength of its investment committee, how the return is measured and what the return is. It's also important to get answers on how well the organization is managing its short-term obligations. The accepted standard is to have at least six months of cash reserve to cover these expenses.

Board members could be personally liable if, as has happened occasionally in the past few years, a nonprofit has not properly withheld payroll taxes. D&O insurance doesn’t cover nonpayment of taxes, Ratcliffe says. So it falls on the individual board member to be responsible.

As for avoiding improprieties, **Melanie Lockwood Herman**, executive director of the **Nonprofit Risk Management Center**, warns that it’s hard for a prospective board member to spot potential financial and governance risks. Herman writes in an e-mail that problems are hidden not because nonprofit boards or CEOs are deceitful but because a board “that airs an organization’s laundry in public is arguably being derelict in its duty to fiercely defend and protect the mission and assets of the nonprofit.”

Herman says prospective directors should use the following checklist: ask what the top three challenges that organization is facing are; ask to speak to a former board member about their experiences; ask for examples of appropriate and inappropriate board member behavior; ask to know about all pending and recently concluded legal claims; and ask whether a D&O liability insurance policy is in place.

Addleman, on the other hand, suggests asking about internal controls and the financials, reading the Form 990, and talking to the CEO and other board members to find out how robust the organization’s governance practices are.

“It cannot be fun to be a nonprofit board member reading about your organization’s improprieties,” Tenenbaum adds. “Even if you have no personal liability risk, there’s certainly reputational risk.”

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