2A. Governance: Are You a Governance Guru?

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Handouts:

1. Putting Governance Into Practice – Case Studies

CAPLAW

Community Action Program Legal Services, Inc.

CAPLAW Governance Case Studies

Prepared by
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Introduction

There has been a great deal of discussion during the last five years over the role that boards should play in overseeing nonprofits and their activities. Some argue that too many boards are passive, failing to provide adequate oversight over scarce resources. These critics can point to all too many board failures that have resulted in fraud and mismanagement. Others are quick to respond that many boards are filled with volunteers, who want to do right by their nonprofits, but who face time constraints, limited knowledge, and other limitations.

Many who serve on boards aren't even clear as to what their role is. Should they come to the monthly meetings, enjoy the coffee and doughnuts, and serve as cheerleaders? Or, are they supposed to take an active role in managing the nonprofit, possibly coming in on Saturday to clean the office, reconcile the checkbook, or stack cans of food in a warehouse? Many know that they should be asking questions at board meetings, but what questions?

Some board members who have taken their roles seriously have asked for training or board orientation. That certainly is a start, but traditionally board training has relied heavily on a lecture format. That is a worthwhile start, particularly in outlining legal, accounting, and financial issues. Lecture is a tried and true format for imparting basic information.

Unfortunately, lectures cannot provide board members with a sense of the hard choices that boards often face. The 11 case studies that follow are designed to provide board members and nonprofit managers with a better sense of the issues that boards should be focused on and what it means to grapple with them. The boards in most of these cases failed miserably in defining and carrying out their oversight function. Sadly, those failures led to agencies closing, cuts in services, people losing their jobs, and skepticism by legislators and grantmakers over whether programs should be funded.

Most people who volunteer to serve on boards certainly don't do so because they want to promote failure. Just the opposite: They want to make a constructive contribution. The case studies are offered as teaching tool that will promote positive oversight and results. They aren't a substitute for hands-on experience, but they should come closer than a lecture in providing board members and nonprofit managers with a sense of the discussion that should be taking place during board meetings.

Media Accounts

Each case is based on media accounts of a Community Action Agency or similar social service agency that experienced problems rooted in governance failures. In some cases, the media accounts have been supplemented with investigatory audits and reports prepared by government agencies and consultants.

Identities

Identifying information is provided if the CAA or other nonprofit no longer exists. This permits full citation to source material. In the case of agencies that still exist, fictitious names

have been substituted for actual names. In all cases, the intention is not to criticize agencies or individuals, but to use the mistakes that others have made as teaching opportunities.

Provocative Questions

These cases studies were prepared by Jack B. Siegel of Charity Governance Consulting LLC. After the facts are set out, each case study asks a number of questions intended for discussion and then provides a brief suggested solution for the case. Some of the questions are intended to be provocative in order to generate a meaningful discussion. No inferences should be drawn from those questions as to the views of Jack or CAPLAW. The suggested solutions represent one viewpoint, but they are not necessarily the best or the only way to view the case.

Discussion

There are 11 cases studies in this series. Those leading the session can use all the cases, or just a few. Whatever the choice, it should permit the participants to engage in a lengthy discussion of each selected case. This exercise will succeed only if the participants are permitted to grapple with the issues posed by the cases through group discussion and debate. That discussion and debate most likely will reveal a divergence of opinion, demonstrating that there is not one right or easy answer to the questions posed.

Background Material

The case studies focus on business, governance, and personnel issues. Lurking in the background are legal considerations. To avoid overpowering the cases with legal rules and commentary, significant portions of the legal discussion has been placed in a document labeled "Background Material". Each case makes reference to relevant portion of the background material. The background material also includes references to useful links and resources.

About the Author

Jack B. Siegel, Esq., CPA, provides consulting services to nonprofits through Charity Governance Consulting LLC. He focuses on board and staff training, governance manuals, financial management, record retention, and special projects. He is the author of *A Desktop Guide for Nonprofit Directors, Officers, and Advisors: Avoiding Trouble While Doing Good* (Wiley 2006), a comprehensive 744-page book addressing the legal, financial, tax, regulatory, and governance issues facing nonprofit boards and senior officers. He also maintains a highly regarded blog, accessible at http://charitygovernance.com. Mr. Siegel holds an LL.M. in taxation from New York University and a master's of management from Northwestern University. He can be contacted at 773.325.2124 or by e-mail at jbsiegel@charitygovernance.com.

About CAPLAW

CAPLAW is a nonprofit membership organization dedicated to providing the legal resources necessary to sustain and strengthen the national Community Action Agency (CAA) network. For over 40 years, since they were first created by the Economic Opportunity Act of 1964, CAAs have been fighting poverty, helping individuals become self-sufficient, building communities, and changing lives. Nationwide, approximately 1,000 CAAs leverage almost $10 billion in total funding, and provide a multitude of services, including job training, Head Start, economic development, energy assistance, and housing.

Through its in-house legal staff and a network of private attorneys, CAPLAW provides legal consultations, training, and publications on a wide variety of legal and management topics. This assistance enables CAAs to operate legally sound organizations and to promote the effective participation of low-income people in the planning and delivery of CAA programs and services, thereby enhancing CAAs' ability to provide the nation's poor with opportunities to improve their quality of life and to achieve their full potential.

Background Information and Resources for the CAPLAW Governance Case Studies

I. Background Information — Setting Compensation

The Head Start administrators, the IRS, and state regulators are each interested in compensation levels and the process by which they are determined.

A. HEAD START LIMITATIONS

Section 653 of the Head Start Act limits the compensation of Head Start staff. The language precludes use of any Federal funds to pay any part of the compensation of an individual employed by a Head Start agency whose compensation exceeds the rate payable for level II of the Executive Schedule, which is currently $172,200 (effective January 2008).

1. COMPENSATION DEFINED

Compensation is specifically defined in Section 653 to include "salaries, bonuses, periodic payments, severance pay, the value of any vacation time, the value of a compensatory or paid leave benefit not [explicitly] excluded and the fair market value of any employee perquisite or benefit not [explicitly] excluded." Explicitly excluded from counting as compensation is "any Head Start agency expenditure for a health, medical, life insurance, disability, retirement or any other employee welfare or pension benefit."

2. THE CAP

The cap precludes any Federal funds being used to pay an individual whose compensation exceeds the cap, not just Head Start grant funds. Moreover, unlike previous policy in which grant funds could be used to pay up to the cap, but not for any compensation that exceeded the cap, the new statutory requirement precludes any funds being used to pay any part of an individual's compensation, if that individual's compensation exceeds the cap. For example, previously if an individual who worked full time for Head Start had a 2008 compensation level of $180,000, that grantee would have been authorized to charge up to $172,200 of that compensation to the Head Start grant, finding $7,800 in non-grant funds to fully pay that individual.

The new requirement will not permit any Head Start (or other Federal) funds, to be used to pay any part of that individual's compensation. That is, all $180,000 would have to come from non-federal sources or the individual's compensation would need to be reduced. It is important to note that this cap applies to all staff who receive any part of their compensation from Head Start (or other federal funding sources), including those whose salaries are part of an indirect cost pool.

3. EFFECTIVE DATE

The Office of Head Start recognizes that some grantees will need to make adjustments to their personnel policies and/or will need to have their indirect cost rate redetermined by their cognizant federal agency. In order to give these agencies a reasonable period of time to make such changes, implementation of the compensation cap will be effective for all Head Start grantees beginning with the awarding of their FY 2009 annual grant award.

4. AUTHORITY

The foregoing discussion is based on a Program Information memorandum, ACF-PI-HS-08-03, issued on May 12, 2008 by the U.S. Department of Health and Human Services (Office of Head Start in the Administration for Children and Families).

B. SETTING COMPENSATION

Although there may be slight differences between how the IRS and state regulators judge the procedures used to set compensation and its reasonableness, in practice, the same procedures

should suffice for both state regulatory and tax purposes. These procedures include: (i) the use of meaningful comparables; (ii) linkage of pay to performance; (iii) the approval of the compensation package by an independent board of directors (or an authorized committee thereof); and (iv) the contemporaneous documentation of the decision and the basis for it.

C. THE INTERMEDIATE SANCTIONS

The intermediate sanctions are a comprehensive set of tax rules designed to assure that compensation paid to key employees and other insiders reflects market-rate compensation. If the IRS determines that the compensation is excessive, it can force the recipient to return the excess to the exempt organization and assess an excise tax equal to 25% of the excess on the recipient.

The centerpiece of this regime is a rebuttable presumption that compensation is reasonable if certain procedures are adhered to when setting the compensation. Specifically, the organization must demonstrate that (i) the compensation arrangement was approved in advance by the board of directors (or a committee thereof); (ii) such board (or committee) was comprised entirely of individuals who do not have conflicts of interest; (iii) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the compensation arrangement; and (iv) such board (or committee) adequately documented the basis for its determination concurrently with the decision.

The rules contemplate otherwise conflicted individuals recusing themselves from the process. A rebuttable presumption does not mean that the IRS cannot question the reasonableness of the compensation. But if the IRS does question compensation, it has the burden of proving the compensation is unreasonable.

1. COMPLEX

Unfortunately, the intermediate sanctions are a complex set of rules. This complexity is attributable to the fact that the rules not only apply to social service agencies, but to large nonprofit hospitals, cultural institutions, and colleges and universities. Smaller social service agencies will want to work with their legal counsel or accounting firm to assure that the rebuttable presumption is available. Competent advisors should be able to provide practical advice without running up large professional fees.

2. DISQUALIFIED PERSONS

The intermediate sanctions only apply to compensation arrangements between the organization and individuals who are referred to as disqualified persons. Disqualified persons include voting members of the board, the president, chief executive officer, chief operating officer, the treasurer, the chief financial officer, and other persons who have substantial influence over the affairs of the organization.

An employee who earns less than $105,000 during the 2008 tax year (this number is indexed for inflation and adjusted annually) generally will not be considered a disqualified person if the employee is not a voting member of the board or one of the officers named earlier. There are related-party rules which can cause someone otherwise not considered to be a disqualified person to be treated as one because of family membership or beneficial ownership interests.

3. THE INCENTIVES

Although people normally think of the intermediate sanctions applying to tax-exempt entities, the operation of these rules has the greatest practical impact on the executive director and other highly-compensated individuals. If the IRS successfully challenges the reasonableness of the executive director's compensation package, it is the executive director who must return any excess benefit to the organization and pay the 25% penalty. Consequently, the executive director and other disqualified persons should be the ones who insist that the necessary conditions are satisfied so as to permit reliance on the rebuttable presumption.

4. COMPARABLES

In a 2006 phone forum, the IRS indicated that reasonable compensation is an amount ordinarily paid for (i) like services (ii) by like enterprises (whether taxable or tax-exempt) (iii) under like circumstances.

a) Services are considered like by examining whether the work is "hands-on" or general involvement, national or local in scope, the number of employees managed, the size of the budget or assets managed, whether the management function involves multiple functions, departments, facilities, or entities, whether the position is full- or part-time, and whether the service is in multiple capacities or for a group of related entities.

b) Enterprises are considered alike by examining budget, revenues, number of employees, and persons served, whether the same type of business is involved (pre-school vs. university), and whether there is a mix of non-profit and for-profit entities. Additionally, the entities must be competing for the same pool of talent.

c) To ascertain whether the circumstances surrounding two nonprofits are similar, the analysis should ascertain whether the nonprofits are providing the services in an urban or rural environment, in similar size geographic areas, and in areas with the same costs of living. To be comparable, the compensation must consist of a similar mix of compensation items, and include all compensation items (whether taxable or not).

d) Organizations should consider reviewing Form 990s for comparable organizations to help them develop compensation comparables. Organizations are required to disclose compensation information for their five-highest paid employees, as well as for key employees, officers, and selected others. The redesigned Form 990, which will be first used for the 2008 tax year, requires more detailed compensation disclosures. Organizations can obtain copies of the three most recent Form 990s for most charitable and other tax-exempt organizations at http://www.guidestar.org

D. BEST PRACTICES

1. USE A COMPENSATION COMMITTEE

Developing a compensation package is a time-consuming process. The board can best preserve valuable meeting time by delegating to a compensation committee the task of arriving at an appropriate compensation package for the executive director and any other designated employees. Once the committee has developed a recommendation, it should then present the recommendation to the full board for review and approval.

2. USE A TALLY SHEET

Each member of the board should understand the form and the amount of compensation being paid to the executive director and other key employees. A one- or two-page tally sheet should be distributed to each board member before a compensation package is approved. It should list and succinctly value each item in the compensation package.

3. ASSURE BOARD INDEPENDENCE

Those approving the executive director's compensation should be independent. Board members should not be related to the executive director or have a financial relationship with the organization that is controlled by the executive director or someone who reports to the executive director. For example, the board may have a lawyer as a member. Arguably, that lawyer is not independent if her law firm provides legal services to the organization and the executive director is the one who selects the law firm. Unfortunately, for purposes of the intermediate sanctions, the IRS has been less than forthcoming in defining the outer limits of independence.

4. LINK PAY TO PERFORMANCE

Compensation levels and bonuses should always be linked to performance. Setting compensation goes hand in hand with evaluating performance and setting goals. Boards should avoid routinely ratcheting up compensation levels simply because of the passage of another

year. In other words, pay for performance, not seniority.

5. AVOID THE LAKE WOBEGONE EFFECT

Garrison Keillor has famously said that the residents of his fictional Lake Wobegone boast that all their children are above average. Too many nonprofits believe the same of their "average" executive director. When relying on comparables, many organizations simply place their executive director at the 70th percentile. There are legitimate reasons why an executive director should be paid at a rate that places him or her below the 50th percentile. One is inexperience. Before paying an executive director at the 70th or 80th percentile, the organization should be able to demonstrate through concrete evidence that the executive director performs better than most other executive directors working for comparable organizations.

6. RELY ON MEANINGFUL COMPARABLES

The IRS wants to see organizations rely on comparables when setting compensation. Those comparables must be meaningful. That means making sure that the organizations used for comparison are similar to the organization relying on the comparables. To be considered comparable, an organization should conduct similar programs, be relatively equal in size, and have a similar workforce. It certainly is permissible—and may even be enlightening—to include outliers in the data set, but the people relying on the comparables must analyze all the data, recognizing the differences and explaining why those differences may or may not be relevant. In sum, compare apples to apples, but looking at oranges is certainly permissible as a part of an effort to gain a deeper perspective.

7. AVOID BUILT-IN CONFLICTS WHEN USING A COMPENSATION CONSULTANT

Some organizations will use a consultant to help them develop compensation packages for executive officers. This is appropriate, but only if the consultant is independent. The board should not rely on a compensation consultant who is already performing consulting work for the organization, particularly if the executive director or other key employee retains the consultant. In that situation, the consultant has a built-in incentive to protect the benefits, human resources, and actuarial work performed for the organization by recommending higher than appropriate compensation for the executive director or other key employees. One-stop shopping may at first appear to be efficient, but it could prove costly and should therefore be avoided.

E. RESOURCES

The following resources may prove useful to anyone who is looking for more detailed information.

1. Letter from the Massachusetts Attorney General to Citi Performing Arts Center, http://www.charitygovernance.com/charity_governance/files/2007_12_05_citicenter_attachment1.pdf.

This letter certainly is not the final word, nor should it be viewed as a legal requirement mandating a specific set of procedures. The letter was the culminating step in an investigation by the Massachusetts Attorney General into whether an arts group's executive director was overcompensated. The analysis provides an excellent example of how any board should approach the determination of compensation.

2. House Committee on Oversight and Government Reform, EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS (Majority Staff Report, December 2007), available at http://oversight.house.gov/documents/20071205100928.pdf

3. Brian H. Vogel and Charles W. Quatt, DOLLARS AND SENSE: THE NONPROFIT BOARD'S GUIDE TO DETERMINING EXECUTIVE COMPENSATION (BoardSource 2005)

4. Executive Compensation: Audio version of

teleconference seminar, published by BoardSource and available at http://www.boardsource.org

5. The Intermediate Sanctions: Treasury Regulation Section 53.4958.

6. Bruce Hopkins, THE LAW OF INTERMEDIATE SANCTIONS: A GUIDE FOR NONPROFITS (Wiley 2003). This book is out of print, but used copies can probably be found on the Web.

7. IRS Continuing Education Materials

a) "Automatic" Excess Benefit Transactions under IRC 4958, http://www.irs.gov/pub/irs-tege/eotopice04.pdf
b) Intermediate Sanctions (IRC 4958) Update, http://www.irs.gov/pub/irs-tege/eotopice03.pdf
c) Section 4958 Update, http://www.irs.gov/pub/irs-tege/eotopicb00.pdf

8. IRS Executive Compensation Initiative—A 2007 report on how the IRS is applying the intermediate sanctions in the field, http://www.irs.gov/charities/charitable/article/0,,id=169164,00.html

9. Organizations seeking comparables may want to consider using the Economic Research Institution's Nonprofit Compensation database, available through subscription at http://www.erieri.com/index.cfm?fuseaction=ERICA.Main&trkid=479-161. The database is taken from the IRS Form 990 and 990EZ. The annual subscription rate for the professional edition is currently listed as $489. Demo software can be requested.

II. Background Information — Incentive Compensation

Incentive compensation raises issues under both federal tax law and the rules governing federal and CSBG grants.

A. FEDERAL TAX LAW

The following are considerations that should be taken into account when developing any bonus or incentive compensation plan:

1. BUSINESS PURPOSE.
There should be a "real and discernable business purpose" that furthers the CAA's exempt purpose (for example: motivating and reinforcing efficiency and quality of service and encouraging cost containment). The plan must not be a device to distribute profits to principals of the organization or transform the organization's principal activity into a joint venture.

2. APPROVAL BY INDEPENDENT BOARD
The plan should be established and implemented by an independent board of directors or an independent committee of the board, such as a personnel or compensation committee.

3. SAFEGUARDS
The plan should include safeguards to prevent a reduction in the charitable services the agency would otherwise provide and to prevent abuse of the plan (for example, taking steps to ensure that the agency is on track to provide all the program services it has committed to in its annual program budgets and plans before paying out bonuses and to ensure that program managers do not set aside funds for the bonus pool that should be used to provide program services).

4. REASONABLE COMPENSATION
Total compensation – including amounts paid under the plan, plus all other forms of compensation – provided to each employee should be reasonable.

5. CAP ON THE BONUS
The bonus plan should include a cap on the size of a bonus that employees may earn (e.g., a certain percentage of their regular salaries). This will help the CAA determine in advance whether the employee's total compensation is reasonable and will help in budgeting for payments under the plan.

6. OBJECTIVE STANDARDS
The bonus plan should set objective standards for judging employee performance that are linked to the agency's accomplishment of its exempt purposes. It should also reward an employee for her actual accomplishments, rather than for the overall performance of parts of the organization in which the employee does not do significant work or on which the employee's own work performance is not likely to have an impact.

7. RIGHT TO CANCEL
The plan should specify that the board may, in its sole discretion, cancel the bonus plan at any time if doing so is in the CAA's best interests and that the board may cancel or reduce potential bonus awards at the time they are scheduled to be paid if payment of the awards would be in violation of any law or regulation, would jeopardize the agency's ability to meet its obligations to funders, would jeopardize the agency's ability to carry out its tax-exempt purposes or would otherwise not be in its best interest. (The agency should discuss with its employment law attorney how to structure and operate the plan so that cancellation of the plan or cancellation or reduction of potential bonus award will not run afoul of any state law concerning the payment of wages. In particular, if the plan can be unilaterally canceled, that fact and the basis for cancellation should be spelled out in the employee handbook or other appropriate written document made available to employees.)

B. FEDERAL GRANT LAW

Any incentive compensation arrangement must also be structured to comply with the requirements of OMB Circular A-122, Cost Principles for Non-Profit Organizations. Under Circular A-122, incentive compensation is an allowable cost

under a federal grant to the extent that: (i) overall compensation is determined to be reasonable (this requirement is consistent with the IRS requirement that an employee's total compensation be reasonable) and (ii) the incentive compensation is paid or accrued either: (a) under an agreement entered into in good faith between the organization and the employees receiving the incentive compensation before the employees performed the services on which the incentive compensation was based or (b) pursuant to an established plan followed by the organization so consistently as to imply an agreement to make an incentive compensation payment.

C. RESOURCES

1. See I_E, above.

2. See Private Letter Ruling 200601030 (Jan. 6, 2006); IRS Information Letter 2002-0021 (Jan. 9, 2002); and General Counsel Memorandum 39674 (June 17, 1987).

3. See OMB Circular A-122, Att. B, ¶ 8.j (available online at http://www.whitehouse.gov/omb/circulars/a122/a122_2004.html, which is not codified at 2 CFR Part 230, App. B

III. BACKGROUND INFORMATION — CONFLICTS OF INTEREST

Many believe that conflicts of interest are easily dealt with: Just adopt a policy, make sure that interested parties recuse themselves, and prices are determined by competitive bids or evaluated using independent appraisals. Unfortunately conflicts of interests are not so easily dealt with.

A. CONFLICTS-OF-INTEREST POLICIES

There are hundreds of conflicts-of-interest policies available on the Internet. It is tempting to just copy and adopt one of those policies. This is to be avoided. Any meaningful conflicts-of-interest policy must take into account the particular nonprofit's specific circumstances and culture. At a minimum, the board should consider:

1. WHO?

Who should the policy apply to? Officers, directors, and employees are likely candidates, but what about independent contractors, vendors, volunteers, and beneficiaries of services? And what about past employees or retired directors, or family members or related entities?

2. WHAT?

What conflicts are covered? Everybody agrees that transactions between the organization and employees should be covered, but what about

a) The local banker who is a nonprofit director if his bank agrees to make a market rate loan to the nonprofit? At first, this seems like a great idea, but what happens if the organization defaults on the loan and the banker also sits on the organization's finance committee?
b) What about the education expert who sits on the nonprofit's board and agrees to provide her advice on a particular matter for free? Price certainly isn't the issue, but doesn't this potentially provide her with the equivalent of a super-majority vote because she can manipulate the board and the action it takes by how she formulates her advice.
c) What about the architect who is the son of the board chair and who is submitting a bid for work?

3. NOTIFICATION

If a person subject to the policy becomes aware of a potential conflict, who should he notify? Should the employee notify his immediate supervisor, or should there be one person who centrally reviews all conflicts?

4. ENFORCEMENT

How is the policy enforced? Typically, under the terms of the policy, those who are covered by the policy have an affirmative duty to identify potential conflicts.

a) Should those subject to the policy be required to re-affirm it (and their compliance) once a year?
b) Should someone be charged with auditing transactions to make sure there are no conflicts?

5. PENALTIES

The policy should clearly spell out the consequences of violating the policy, particularly if violations will result in a job action such as termination or suspension. In the case of a director, is an undisclosed conflict a basis for automatic removal?

B. DUALITY

With the tripartite board structure, the boards of CAAs are divided between low-income community members (and people who represent such individuals), government representatives, and other interested parties. Although probably unanticipated by the architects of this structure, this segmentation creates dual loyalties that pose potential conflicts.

1. LOW-INCOME REPRESENTATIVES

Is a low-income representative supposed to act in the best interests of low-income individuals served by the agency or in the best interests of the agency? Some people will assume the two focuses neatly dovetail, but suppose someone proposes spending $2 million on a new program that benefits low-income members of the com-

munity when the organization is already running significant deficits?

2. GOVERNMENT REPRESENTATIVES

Assume the organization's bylaws provide that the mayor is an ex-officio board member, with full voting power. Further assume that the mayor has been advised by his staff to recommend that grant money be awarded to a competing CAA or other social service agency. How should the mayor resolve the conflict resulting from his dual roles as mayor and board member? He is supposed to do what is best for both the city and the organization.

A strong case can be made that the organization's bylaws and conflicts-of-interest policy address the potential for conflicting loyalties. Wherever addressed, the policy regarding these conflicts should be established from the outset and clearly explained to all interested parties.

C. OMB CIRCULAR A-110 (NOW CODIFIED AS 2 CFR PART 215)

The Office of Management and Budget has issued Circular A-110, Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations. These rules generally apply to federal grants and sub-grants, including some state-administered block grants, such as CSBG grants. The federal rules require that states must "ensure that cost and accounting standards of [the OMB] apply to a recipient of [CSBG] funds" See 42 USC 9916(a)(1)(B).

1. CONFLICTS OF INTEREST

Paragraph 42 of Circular A-110 requires that the grant recipient maintain written standards of conduct governing the performance of its employees engaged in the award and administration of contracts. No employee, officer, or agent may participate in the selection, award, or administration of a contract supported by Federal funds if a real or apparent conflict of interest would be involved. Such a conflict arises when the employee, officer, or agent, any member of her immediate family, her partner, or an organization which employs or is about to employ any of the indicated parties, has a financial or other interest in the firm selected for an award. The officers, employees, and agents of the recipient must neither solicit nor accept gratuities, favors, or anything of monetary value from contractors or other interested parties. However, organizations may set standards for situations in which the financial interest is not substantial or the gift is an unsolicited item of nominal value. The standards of conduct must provide for disciplinary actions to be applied for violations of the rules.

2. CONTRACT AWARDS

Paragraph 43 addresses the rules that apply to an agency's expenditure of grant funds, requiring competitive bidding. The grant recipient must be alert to organizational conflicts of interest as well as noncompetitive practices among contractors that may restrict or eliminate competition. The grant recipient is further instructed that when it awards contracts, the award is to be made to the bidder whose bid or offer is responsive to the solicitation and is most advantageous to the recipient, with price, quality and other factors considered.

D. HEAD START LEGISLATION

Section 642 of the Improving Head Start for School Readiness Act of 2007 addresses program governance, with subsection (c) focusing specifically on conflicts of interest. Under this recently enacted legislation, members of the governing body may not (i) have a financial conflict of interest with the Head Start agency (including any delegate agency); (ii) receive compensation for serving on the governing body or for providing services to the Head Start agency; or (iii) be employed, or have members of their immediate family be employed, by the Head Start agency (including any delegate agency).

Moreover, the governing body is given an affirmative duty to operate independent of staff employed by the agency. There are limited exceptions for individuals who hold a board position as a result of public election or political appointment if such position carries with it a concurrent appointment to serve as a member of a Head Start agency's

governing body. In such case, the individual can receive compensation if it payable as a consequence of the election or the appointment. Additionally such person can serve despite a conflict described in (ii) or (iii) above. These rules are now codified at 42 U.S.C. 9837.

E. IRS FORM 990

Beginning with the 2008 taxable year, the IRS and the public will know whether an organization has a conflicts-of-interest policy. Question 12a of Part VI of the Core Form to the recently revised Form 990 asks whether the organization has a conflicts-of-interest policy. Question 12b then asks whether officers, directors, and key employees are required to disclose annually interests that could give rise to conflicts. Finally, Question 12c asks whether the organization regularly and consistently monitors and enforces compliance of its conflicts-of-interest policy.

F. RESOURCES

The following resources may prove useful to anyone who is looking for more detailed information.

1. Independent Sector, PRINCIPLES OF GOOD GOVERNANCE, available at http://www.nonprofitpanel.org/

2. American Law Institute, PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS: TENTATIVE DRAFT NO. 1 (March 19, 2007).

3. Marion R. Fremont-Smith, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (Belknap Press 2004).

Fremont-Smith is the dean of nonprofit governance. She served as the Assistant Attorney General and Director of the Division of Charities in Massachusetts and is a retired partner of Choate, Hall, and Stewart. The book may be more than many want, but it is what everybody needs. A soft-cover edition is scheduled for publication sometime in 2008.

4. Jack B. Siegel, A DESKTOP GUIDE FOR NONPROFIT DIRECTORS, OFFICERS, AND ADVISORS: AVOIDING TROUBLE WHILE DOING GOOD (Wiley 2006).

IV. BACKGROUND INFORMATION — WHISTLEBLOWERS

A. WHISTLEBLOWER POLICIES

In an effort to open up the line of communication, every organization should give serious considerations to adopting a whistleblower policy.

1. AVAILABILITY

The policy should be available to employees, independent contractors, volunteers, vendors and service providers, and service recipients.

2. RECIPIENT

The policy should identify the person who should receive the report. Policies often direct the whistleblower to a member of the board's audit or finance committee when the concern is over financial matters. In the case of employment practices, policies often direct the whistleblower to contact HR or a member of the organization's board (possibly a member of the board's compensation committee). Every policy should specifically name the person who the report is to be directed, provide for an alternative in that person's absence, and provide contact information.

3. EARLY REPORTING

The policy should encourage early reporting of concerns.

4. METHOD

Reports are best made by telephone or in a secure written form. Potential whistleblowers should be advised to avoid inter-office routing envelopes and e-mail reports. To encourage reports, the policy should state the mechanisms that are in place to protect the whistleblower's identity. For example, whistleblowers might be notified that the whistleblower's phone number will not appear as part of a caller id system when calling a hotline (assuming that is the case). The policy should also advise the potential whistleblower not to leave details as part of voice mail messages.

5. REPORTING THRESHOLD

The policy should require that any report should be made in good faith and be based on objective facts. It should also clearly state that malicious, intentionally false, or trivial reports will not be tolerated and may result in disciplinary action. Employees should be advised that unless the circumstances warrant, they should first address their concerns with their immediate supervisor, or when appropriate, HR. The policy should provide examples of situations where it is appropriate to bypass supervisors such as when there is clear evidence of criminal activity, extensive and ongoing harassment or discrimination, or threat to life.

6. CONFIDENTIALITY

The policy should never guarantee confidentiality, but it should assure that the organization will use reasonable efforts to keep the person's identity confidential if requested. An organization can never guarantee confidentiality because investigations, discovery, court proceedings, and other factors beyond the organization's control may result in the whistleblower's identity becoming known.

7. THE PROCESS

The policy should explain the process: What will happen as a consequence of the report? This aspect of the written policy will have to be general because each report will require different responses. The recipient of the report should respond immediately, notifying the whistleblower that the report has been received and briefly describing the steps that will be taken in response to the report. When possible, the recipient also should tell the whistleblower when the recipient will next contact the whistleblower.

8. INVESTIGATIONS

Investigations stemming from reports should be discreet and made on a need-to-know basis. E-mail and other unsecure modes of communication should be avoided for discussions in connection with the investigation.

9. FOLLOW-UP

The policy should provide for follow-up with the whistleblower to make sure that the whistleblower truly believes that the issue raised has been satisfactorily dealt with. A whistleblower who perceives that his efforts have been ignored is a dangerous person from the organization's standpoint. This is a person who may decide to contact the media, a regulator, or a lawyer.

10. LOGGING AND AUDITS

Each report should be recorded in a secure log. Log entries should include the whistleblower's identity, the date and nature of the report, a description of the responses and the resolution, a statement that the whistleblower has been notified of the resolution, and an indication whether the whistleblower is satisfied with the outcome. A designated compliance officer should audit the logs and the policy periodically. Good candidate for this task include the organization's general counsel, a board member, or the organization's outside legal counsel.

11. RETALIATION

The policy should prohibit retaliation against whistleblowers and specify the consequences resulting from retaliatory actions.

12. AFFIRMATIVE DUTY

Some organizations impose an affirmative duty on employees to report activity that violates organizational ethics codes, other standards, or the law. In theory, this sort of affirmative duty makes sense. Unfortunately, childhood has taught many of us that tattletales and teacher's pets are to be shunned. As a consequence, imposing an affirmative duty to report may provide the organization with a false sense of security. If an organization decides to impose an affirmative duty on its employees, it should clearly spell out the consequences resulting from noncompliance.

13. BOARD REVIEW

The board should periodically receive a report on the nature and number of complaints. The board should consider organizational changes when there are repeated reports raising the same issue.

14. EMPLOYEE HANDBOOK

The policy should be included as part of the employee/volunteer handbook. It should state that it is subject to change at the discretion of management. The policy will need to be communicated to others through memo or contract terms.

B. THIRD-PARTY HOTLINES

Some organizations rely on third-party whistleblower hotlines to assure their employees greater anonymity in filing whistleblower reports. The proliferation of these providers is a direct result of the Sarbanes-Oxley Act of 2002, which mandates that certain publicly-traded corporations provide employees with the opportunity to report certain concerns on an anonymous basis. Anecdotal evidence indicates that nonprofits probably have not widely adopted the use of these third-party hotlines, but some hospitals and universities probably have.

1. EVALUATING THIRD-PARTY HOTLINES

In evaluating any third-party hotline, the CAA should ask the following questions?

a) Is the hotline 24/7/365?
b) Is the hotline staffed by personnel or is it a web-based or e-mail system?
c) How do callers know that it is anonymous? How does a caller's number appear on the caller id system?
d) What is the background of those who answer telephone-based hotlines? Are they lawyers or paralegals? Do they receive special training?
e) Do the operators utilize scripts to conduct the interview or do they make it up as they go? What does the hotline do to assure consistency in how calls are handled?
f) How do the operators record the data? Do they type comments into a computer database? Are phone conversations recorded? If so, how is anonymity maintained?
g) Does the hotline provide callers with

case numbers so that they can call back at a later time with additional information and concerns without the need to start from the beginning?
h) Does the hotline have multi-lingual capabilities?
i) Are calls taken in a call center or in a more private setting?
j) Does the system have time-stamp and other controls that prevent reports from being altered after the fact?
k) How does the hotline report calls to the organization? Are the reports encrypted if transmitted electronically?
l) Does the service offer materials and information sessions to the nonprofit's employees and other stakeholders so they are aware of the system?

Many of these questions also are relevant to a nonprofit that relies on in-house whistleblower reporting schemes.

2. THIRD PARTY SERVICE PROVIDERS

Here are the names and Web addresses for a number of third-parties who provide hot line services:

a) Allegiance at http://www.allegiance.com
b) Clearview at http://www.clearviewpartners.com/
c) Ethical Advocate at http://www.ethicaladvocate.com
d) Ethics Point at http://info.ethicspoint.com
e) Global Compliance at http://www.globalcompliance.com.
f) Lighthouse at http://www.lighthouse-services.com
g) Report Line at http://www.reportline.net
h) Silent Whistle at http://silentwhistle.allegiance.com

CAPLAW has not worked with any of these organizations. The inclusion of their names on this list is not an endorsement of their services. A CAA considering any of these organizations must conduct its own due diligence.

3. COST

A CAA should contact the providers to obtain cost estimates. For ballpark purposes, one provider claimed the cost could be as low as $1.50 per employee per year.

4. MULTIPLE FOCUSES

A CAA that decides to use a hotline service should consider the types of complaints that it wants directed to the hotline. Many of these services focus on financial fraud and abuse, but some services also handle employment practice and client protection (e.g. child or elder abuse by staff members) issues.

C. FALSE CLAIMS ACT

The Federal False Claims Act provides for the imposition of penalties on entities that make false claims to the Federal government. Section 3730(h) of Title 31 of the United States Code provides protection to employees who blow the whistle. Specifically, Section 3730(h) provides:

> Any employee who is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of employment by his or her employer because of lawful acts done by the employee on behalf of his employer or others in furtherance of an action under this section, including investigation for, initiation of, testimony for, or assistance in an action filed or to be filed under this section, shall be entitled to all relief necessary to make the employee whole.

A number of organizations have adopted False Claims Act polices. These are typically hospital systems and other organizations that are dependent on government funding or reimbursement. These policies define what a false claim is, described the consequences from making a false claim, and include references to the organization's whistleblower policy.

D. RETALIATION—SARBANES-OXLEY

In 2002, Congress enacted comprehensive corporate governance legislation directed at publicly-traded companies. This legislation carries the

title "Sarbanes-Oxley Act of 2002." Among its many provisions are four that pertain to whistleblowers, but only one is relevant to CAAs because it applies to all employers rather than just publicly-traded companies. This provision criminalizes retaliation by CAAs and other employers for retaliation against whistleblowers who provides a law enforcement officer with any truthful information relating to the commission or possible commission of any Federal offense.

Specifically, Section 1513 of Title 18 of the United States Code provides:

> Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

E. RETALIATION – FEDERAL EMPLOYMENT LAW

Several of the better-known federal employment laws contain provisions providing protection to whistleblowers.

1. OSHA

To help ensure that employees are, in fact, free to participate in safety and health activities, Section 11(c) of OSHA prohibits any person from discharging or in any manner discriminating against any employee because the employee has exercised rights under OSHA. These rights include complaining to OSHA and seeking an OSHA inspection, participating in an OSHA inspection, and participating or testifying in any proceeding related to an OSHA inspection.

2. ADA

The Americans with Disabilities Act contains whistleblower provisions, which prohibit discrimination against any individual who makes a charge, testifies, assists, or participates in an investigation, proceeding, or hearing under the ADA. Moreover, it is unlawful to coerce, intimidate, threaten, or interfere with any individual who exercises rights granted under the ADA or assists someone to exercise their rights.

3. FLSA

Under Section 215 of Title 29 of the United States Code, it is a violation of the Fair Labor Standards Act to discharge or in any other manner discriminate against any employee because such employee files a complaint or institutes proceedings under the FLSA, or testifies in such a proceeding.

4. FMLA

Under Section 2615 of Title 29 of the United States Code, it is a violation of the Family and Medical Leave Act for any employer to interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the FMLA. Moreover, it is a violation of the FMLA for an employer to discriminate against any individual for opposing practices that are unlawful under the FMLA. The FMLA imposes liability on employers that retaliate against employees for exercising their rights under the FMLA.

F. THE FEDERAL SENTENCING GUIDELINES

Mention the Federal Sentencing Guidelines and most people say, "What do they have to do with nonprofits and corporations?" Actually a lot, if the nonprofit engages in criminal activity. Such activity could result from an employee's efforts to obstruct a federal investigation, cover-up fraudulent reimbursement activity, or any of the other type of crimes that corporations can be charged with. The guidelines instruct judges to take into account the presence of a whistleblower policy when punishing a corporation for the misdeeds of employees that are attributed to the corporation. Chapter 8 of the Federal Sentencing Guidelines (2004) provides as follows:

> The guidelines and policy statements in this chapter apply when the convicted defendant is an organization. Organizations can act only through agents and, under federal criminal

law, generally are vicariously liable for offenses committed by their agents. At the same time, individual agents are responsible for their own criminal conduct. Federal prosecutions of organizations therefore frequently involve individual and organizational co-defendants. Convicted individual agents of organizations are sentenced in accordance with the guidelines and policy statements in the preceding chapters. This chapter is designed so that the sanctions imposed upon organizations and their agents, taken together, will provide just punishment, adequate deterrence, and incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct.... These guidelines offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program. The prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical conduct and in complying fully with all applicable laws.

Section 8B2.1(b)(5) then provides:

The organization shall take reasonable steps—

(A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;

(B) to evaluate periodically the effectiveness of the organization's compliance and ethics program; and

(C) to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.

G. STATE ANALOGUES

State laws also provide protection to whistleblowers. These protections are often analogous to the ones under federal law, or they can take the form of more general protections under state fair labor laws. The following are two examples of state laws:

1. ILLINOIS WHISTLEBLOWER ACT. Under Illinois 740 ILCS 174, an employer cannot make, adopt, or enforce any rule, regulation, or policy preventing an employee from disclosing information to a government or law enforcement agency if the employee has reasonable cause to believe that the information discloses a violation of a state or federal law, rule, or regulation. Nor may an employer retaliate against an employee for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of a state or federal law, rule, or regulation. The act provides the employee with the right to bring a lawsuit for damages in the event of a prohibited retaliation.

2. CALIFORNIA LABOR CODE. Section 1102.5 of California's Labor Code provides that no employer may make, adopt, or enforce any rule, regulation, or policy preventing an employee from disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation. Moreover, no employer may retaliate against an employee for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation.

H. RESOURCES

The following resources may prove useful to anyone who is looking for more detailed information.

1. Stephen M. Kohn, Michael D. Kohn, and David K. Colapinto, WHISTLEBLOWER LAW:

A GUIDE TO LEGAL PROTECTIONS FOR CORPORATE EMPLOYEES (Praeger 2004).

2. Policies found on the Web should never be adopted by an organization without a thorough review and analysis of the policy in terms of the organization's own culture, needs, or operating environment. With that caveat, CAAs should google the phrase "whistleblower policy." This search will return a number of policy examples which will show how other organizations have dealt with the issue.

V. Background Information — Evaluating the Board Chair

The members of the board should not automatically reappoint the board chair to repeated terms unless the board chair is adequately discharging his duties. A board chair is a good one if the chair:

A. Starts and ends the meetings on schedule.

B. Adheres to an agenda.

C. Keeps the board informed of all major issues and seeks board member input.

D. Maintains decorum during board meetings.

E. Curbs extraneous comments and digressions during board meetings.

F. Avoids creating board factions or regularly siding with one existing faction.

G. Demonstrates respect for different points of view.

H. Maintains an even-temperament.

I. Appears and is approachable.

J. Delegates tasks to appropriate committees and individuals on the board.

K. Fosters and maintains an excellent working relationship with the executive director and staff members who have regular contact with the board.

L. Stays on top of ongoing issues and problems, asking for regular or progress reports from the appropriate individuals or committees.

M. Demonstrates follow through.

N. Anticipates potential problems before they become actual problems.

O. Seeks help from outside experts (e.g., lawyers, accountants, and consultants) when the board or the organization lack the expertise (as opposed to winging it).

P. Acknowledges when a mistake has been made.

Q. Refuses to tolerate efforts to circumvent rules or engage in illegal activity.

R. Keeps an eye on the long-term direction of the organization.

S. Provides a good public face for the organization.

T. Takes the board's oversight function seriously.

VI. Background Information — Financial Reporting, Internal Controls, and Auditing Standards

A. RESOURCES

The following resources may prove useful to anyone who is looking for more detailed information.

1. AICPA, NOT-FOR-PROFIT AUDIT AND ACCOUNTING GUIDE (Updated Annually)

2. Gerald M. Zack, FRAUD AND ABUSE IN NONPROFIT ORGANIZATIONS: A GUIDE TO PREVENTION AND DETECTION (Wiley 2003).

3. Bruce Chase, NOT-FOR-PROFIT ACCOUNTING AND REPORTING: FROM START TO FINISH (AICPA 2006).

4. William E. Thompson, INTERNAL CONTROLS: DESIGN AND DOCUMENTATION (AICPA 2006).

5. Phil Sherman, ANALYTICAL PROCEDURES FOR NONPROFIT ORGANIZATIONS (AICPA 2005).

6. STATEMENTS ON AUDITING STANDARDS NO 99: CONSIDERATIONS OF FRAUD IN FINANCIAL STATEMENT AUDITS (AICPA 2002).

This auditing standard was promulgated in the aftermath of the Enron, WorldCom, Global Crossing, and other corporate scandals that came to light in 2001. It recognizes that the CPA's primary purpose in conducting a financial statement audit is not the detection of fraud, but that the public nevertheless assumes that is exactly the purpose of an audit. Although directed at external audits, this relatively short guide is an important resource for nonprofit broads because its focus is more on thinking about on the big-picture aspects of fraud rather than specific and technical methods for detecting fraud.

Case 3: Selecting Tripartite Board Members

I. Relevant Statute

Section 9910 of Chapter 106 of Title 42 to the United States Code mandates that to be an eligible entity for purposes of receiving Community Services Block Grant (CSBG) funds from a state, an organization must have a tripartite board. The U.S. Department of Health and Human Services (Office of Community Services in the Administration of Children and Families) issued Community Services Block Grant Program Information Memorandum 82 (March 23, 2005) to provide detailed guidance regarding the requirement that CSBG "eligible entities" be limited to entities with tripartite boards. Note that some small amount of CSBG grants are given to non-eligible entities that do not have tripartite boards.

Under a tripartite configuration, at least 1/3 of the members of the tripartite board must be persons chosen in accordance with democratic selection procedures to assure that those members are representative of low-income individuals and families in the neighborhood served. Each representative of low-income individuals and families selected to represent a specific neighborhood must reside in the neighborhood represented by the member.

II. Context

Many CAAs have discovered that finding board members to fill all the positions on the board can be challenging. These positions are uncompensated, meaning that those serving must do so solely out of a desire to improve their communities. This case is based on actual events, but the facts have been altered. It examines the procedures used by a nonprofit CAA to select the low-income representatives on the board. Although selection procedures do vary, there are recurring and common issues which must be addressed in formulating whatever procedures are adopted.

III. Facts

Green Community Action Agency (Green CAA) is a CAA with a $40 million annual budget. Located in a major metropolitan area, Green CAA operates a Head Start program, together with other programs aimed at assisting low-income individuals living in the community. Green CAA's board is comprised of 18 directors. One-third of the board members are elected by the community at large, 1/3 are appointed by governmental bodies, and 1/3 are elected by agencies serving the community. To qualify for election as a community representative, an individual must be 18, live in the community, and present nomination papers with 200 signatures. Write-ins are permitted.

A. One Troublesome Candidate

In a recent election, Joe was elected to Green CAA's board with just 38 write-in votes. The local newspaper reported after the election that Joe was a convicted felon (forgery). At the time of his election, Joe was charged with defrauding a bank of $17,000. He was subsequently convicted and sentenced to two years in prison. Joe insisted upon assuming his seat on the board.

B. Retention of PR Firm

Green CAA hired a public relations consultant to publicize the then upcoming election. The consultant was paid $6,300, with bonus amounts payable if certain levels of participation were achieved.

C. Nomination Papers

Only one candidate was placed on the ballot through the nomination process. Others fell short of the 200-signature requirement despite efforts to satisfy it. This meant that five of the six positions were filled by write-in candidates who received the most votes.

IV. Discussion Questions

The following questions are offered for discussion:

A. Director Qualifications

Should Green CAA amend the director qualification provision in its bylaws to exclude convicted felons from serving on its board?

1. Should the exclusion be a blanket one, or should it focus on the nature of the felony offense? The federal government's suspension and debarment rules (2 CFR Part 180) require a federal grantee to certify, among other things, that neither the organization nor its principals (which include board members) have been convicted of fraud, forgery, bribery, embezzlement, etc. within the previous three years.

2. Should the exclusion be a temporally-based one so that someone who was convicted of a crime at age 19, but who has since lived an exemplary life can serve?

3. Should someone who is convicted of a felony during their term automatically be terminated as a board member?

B. Background Checks

Should the organization's bylaws require that all candidates for director positions undergo background checks? Alternatively, should successful candidates be required to sign a statement certifying that they satisfy the requirements for a board position that are set out in the bylaws? Or should only officers with signing authority on checks, contracts etc. or other access to CAA assets be required to sign a statement? Should those officers be required to undergo credit checks before assuming their positions?

C. Staggered Terms

Should the six elected directors be divided into three classes of two directors, with 1/3 of the board coming up for election each year? Would that structure improve board decisions? How would it affect the balance of power between Green CAA's executive director and the board?

V. One Suggested Solution

A. Overview

Whenever rules don't work, those subject to them should seek change. In the case of Green CAA, the nomination procedure was not producing a sufficient number of candidates because the 200-signature requirement was too high. The idea behind the requirement was to assure that those ultimately filling the positions reserved for low-income individuals had widespread community support. That is a laudable goal, but the process for achieving it failed. A new procedure should be crafted. That might mean reducing the number of required signatures to 50, or holding a meeting in each neighborhood where those who are interested give a speech, with those attending the meeting voting for two candidates. The meeting could be conducted in conjunction with a substantive forum or similar program on a topic of interest to low-income individuals in the community. The bottom line: If a procedure is not properly working, a CAA should not hesitate to modify the procedure through changes to its bylaws, or if necessary, working with state or local authorities to make changes to laws and regulations governing the process.

B. Background Checks

Requiring background checks probably will create public relations problems. Moreover, background checks may cause some good candidates to decide against seeking a position, particularly if a person doesn't want a past problem publicly disclosed. (One possibility would be to limit background checks to the board chair and treasurer.) On the other hand, requiring each board member to sign a written statement that he satisfies the qualification requirements is probably a good idea.

C. Exclusion Based on Felony Convictions

Blanket exclusion for felony convictions is probably too broad. Many boards would probably be willing to seat a 50-year old woman who was convicted of shoplifting at age 17, but who then went to a community college, became a respected teacher, and has lived in the community for the last 25 years. On the other hand, many people would want to exclude someone who had ten successive felony convictions tied to violent crimes, particularly if the last conviction was within the last five years. Also, boards should exclude anyone who cannot sign the debarment and suspension certification.

The bylaws should establish that each board member must satisfy the membership requirements. At a minimum, members should be at least 18 years of age and be of sound mind. (Bylaws should include incapacity in examples of cause for removal.) A requirement that a board member must resign if the member is convicted of a felony during her term is appropriate, as is a requirement that each board member regularly attend meetings. Each board is likely to arrive at a unique formulation of any requirement that looks to past felony convictions as a screening device. Whatever the requirements, having them spelled out in advance assures consistent application and due process in their administration. After individuals have been selected to serve through the appropriate selection process, the board should review whether each candidate meets the minimum requirements and only after doing so, vote to seat candidates as board members. Too many boards don't focus on membership requirements. This can pose a problem if the circumstances warrant not seating a newly-elected member or removing an existing member.

D. Staggered Terms

Staggering board member terms is an excellent idea because it preserves institutional memory. The balance of power shifts to the executive director whenever there are wholesale replacements of existing board members. Then the new members cannot rely on the experience of other board members, but must look to the executive director for guidance.

For those who are unfamiliar with staggered terms or director classes, this is a widespread practice. Assuming there is not legislation or regulations providing what are conflicting requirements, a term structure is both advisable and easy to implement.

Case 7: Social Entrepeneurship and Conflicts of Interest

I. Context

The hot trend in philanthropy is social entrepreneurship, a term with ambiguous meaning. Advocates of this trend know that they want to do more than distribute cans of food to the poor or provide direct energy assistance to low-income homeowners and renters. This has led to a number of creative partnerships between nonprofits and for-profit entities. Although the resulting enterprises can be exciting and innovative, they also pose governance issues for the nonprofit partners, particularly when the nonprofit's directors and employees hold an ownership interest in the enterprise.

This case study looks at social entrepreneurship. Although the facts are fictional, they are loosely based on a number of enterprises that do exist.

II. Facts

Grey Community Action Agency (Grey CAA) operates Head Start, weatherization, nutrition for the elderly, energy assistance, and a number of other programs in a predominantly Latino neighborhood located in a major metropolitan area. It also operates an afterschool program for middle and high school students, providing them a place to go afterschool to do their homework, participate in sports and arts activities, and enjoy a healthy snack. Marta Delgado is Grey CAA's executive director. Delgado had a brainstorm shortly after returning from a conference on social entrepreneurship in Los Angeles. Larry Wilcox, one of her board members is a No Sweat franchisee, a business that provides afterschool college preparatory services to wealthy high school students throughout the country. Delgado decided to approach Wilcox about partnering with Grey CAA to open a No Sweat program to serve low-income students.

Delgado and Wilcox having been talking about the idea for the last several months. Wilcox is convinced that No Sweat will be willing to provide a franchise for the Latino community if Grey CAA is willing to provide 49% of the necessary capital. He has proposed that he and Delgado provide the remaining 51% of the capital in exchange for a 51% interest in the venture. He believes that No Sweat will be willing to offer the franchise at a 60% reduction in the fee that the franchisee must pay because No Sweat's founder has expressed an interest in helping low-income youth with the profits that No Sweat has earned from the families of wealthy high school students.

Wilcox has suggested that the program operate on just Saturdays and Sundays because Grey CAA's afterschool facility goes unused on the weekends. He also has suggested that No Sweat hire some of the teachers and aides from those public school teachers and staff members who supervise the afterschool program. The teachers provide their services in the afterschool program on a volunteer basis and the aids are paid $10 to $15 per hour. The opportunity to earn some extra money on the weekends would be a good way to reward for these individuals. The preliminary financial projections for the proposal estimate that teachers in the program will be paid $35 an hour and the aides will receive $20 per hour.

A. Structure

The proposal calls for the following structure. No Sweat will operate as a limited liability company. Grey CAA will have a 49% ownership interest, and Delgado and Wilcox will each hold 25.5% interests.

B. Board Approval and Opening

Delgado and Wilcox work on the plan for several months before taking the idea to Grey CAA's board. Delgado is both excited at the prospect of helping kids in her community better prepare for college and a little apprehensive about the $50,000 mortgage loan she will have to take out on her home to fund her share of the investment.

After several special board meetings, the board votes 16 to 9 in favor of making the investment. Six months later, No Sweat facility opens to great enthusiasm from the community. The $40 weekly fee is admittedly high for some families, but it is only 20% of the fee charged to students at other No Sweat facilities. Grey was able to obtain a special grant from the state to provide scholarships for 20% of the students participating in the weekend program. Those board members who initially had reservations had to admit this was an excellent idea given the community's overwhelmingly positive response.

C. Two Years Later

With waiting lists to participate in the weekend program, it is hard to imagine any problems with the No Sweat initiative, but unfortunately they have surfaced, including the following ones:

1. Trouble Staffing the Afternoon Program

Grey CAA has had to cut enrollment in its afternoon program by 35% due to staff shortages. Although several volunteers in the afternoon program were enthusiastic about the opportunity to earn a little extra money, they soon discovered that they just didn't have the time to spend with their families. To correct the problem, the volunteers significantly cut back on the hours they devoted to the afterschool program.

2. Unfavorable Audit

The state CSBG office determined that No Sweat was not paying sufficient rent for use of the facility on the weekend. The auditors also objected to the fact that No Sweat was named as an insured on Grey CAA's general liability policy, but provided no reimbursement for its share of the premium. Delgado argued that the amount to be reimbursed was factored into the rent. The auditors were also concerned that No Sweat routinely used computers that had been provided for the students in the afterschool program without reimbursing Grey CAA.

3. Delgado's Response

Delgado pointed out to the board that the No Sweat facility has proved to be a worthwhile project for Grey CAA. It had already received $10,000 on its investment, as well as greater participation by members of the community in its other programs. She also told the board that use of the computers was in furtherance of Grey CAA's mission of assisting young people living in the community so the auditors were likely to back off their demand that No Sweat reimburse Grey CAA for its use of the computers.

4. Enrique Rayo's Response

Enrique Rayo, who has been a member of Grey CAA's board for over a decade, always objected to the No Sweat proposal. He believed it posed serious conflicts of interest for Delgado and would prove to be a distraction. Rayo wants to see the audited financial statements for No Sweat, but Delgado claims that this not necessary. She and Wilcox have decided not to make the statements available because they don't want outsiders to understand No Sweat's cost structure.

III. Discussion Questions

The following questions are offered for discussion:

A. Should CAAs limit their activities to providing traditional social services, or should they look to more entrepreneurial business enterprises to improve the lives of low-income people?

B. What factors should a CAA consider when it is deciding whether to embark on a nontraditional program or partnering with a for-profit entity?

C. Should Grey CAA's board have approved the arrangement with Delgado, or should it have prohibited all Grey officers, directors, or employees from participating as investors in the venture and retained total ownership and control over the franchise?

D. Assuming Grey agreed to permit Delgado to participate, what provisions should it have required in the operating agreement and other organizational documents to protect its interests?

E. If Grey CAA's program participants were benefiting from the program, must Grey CAA nevertheless receive fair market value rent for the use of its facilities and must it be reimbursed for insurance, computer usage, and other benefits that are provided to No Sweat through joint use of facilities?

F. Are there any tax ramifications to this arrangement?

IV. One Suggested Solution

A. CAA as a Social Entrepreneurs

There is no correct answer to the question as to whether CAAs should act as social entrepreneurs. Many CAAs prefer to focus on traditional programs to serve low-income individuals, including Head Start, Weatherization, energy assistance, elder and child nutrition, and counseling, among other services. Others have chosen to add what might be characterized as innovative or exotic projects to their program portfolios. Both approaches can make significant differences in the lives of low-income individuals if properly administered.

No doubt each CAA board will arrive at a slightly different approach when it comes to social entrepreneurship. The board must be actively involved in the decision process whatever the approach. The sort of philosophical questions that surround social entrepreneurship are exactly the questions that boards are tasked with asking.

B. Approving the Arrangement with Delgado

Grey CAA's board should have rejected the arrangement with Delgado, but not necessarily the idea. Delgado had a clear conflict of interest. Once she had an ownership interest in No Sweat, her financial interests would inevitably lead her to favor No Sweat over other CAA programs should there be conflicting choices. This does not mean Delgado is an evil person, just a person who is subject to human nature.

Recall that some volunteers stopped working in the afterschool program once they were provided with an opportunity to make money through No Sweat. One could blame both Delgado and the board for not anticipating this possibility, but there are only so many problems that decisionmakers can anticipate. Once the problem became apparent, why didn't Delgado make continued participation in the afterschool programs a condition to participating in the financially lucrative weekend program? Is it because that would make finding weekend teachers more difficult, thereby reducing profits? Delgado may not be that mercenary, but the conflict and the line of reasoning that comes with it should be apparent.

Setting aside conflicts, the board also should have taken appearances into account. If Grey CAA ever finds itself subject to media scrutiny, this arrangement is likely to be become public knowledge. The board might be able to rationalize the conflict, but members of the media and other watchdogs will inevitably criticize this sort of arrangement. Might adverse publicity hurt fundraising efforts or public support?

C. Insurance, Rent and Computers

The board should be criticized for its apparent failure to focus on the details. Normally, those details should be left to the CAA's officers and employees, but the conflict in this case requires much more vigilant oversight. Somebody other than Delgado and those who report to her should have represented Grey CAA's interests in the negotiating and structuring of the arrangement. That means separate legal counsel representing the board or the board committee negotiating the arrangement.

If the business plan called for No Sweat to rely on Grey CAA for insurance or computer equipment, then Grey CAA should have either received credit for the value of those items when it re-

ceived its interest in the enterprise or there should have been an agreement providing for compensation. There also should have been a negotiated lease covering the use of Grey CAA's facilities. Once again, someone other than Delgado should have represented Grey CAA in the negotiations. It is not at all surprising that the state auditors questioned the arrangement. The basic question: Is the failure of No Sweat to reimburse Grey CAA for No Sweat's allocable share of these costs an innocent oversight, or does it represent intentional fraud.

D. Labor and Employment Law Issues

The Fair Labor Standards Act requires that employers pay the minimum wage and also pay overtime if an employee works more than 40 hours in a work week.

1. Paid Teachers and Volunteers

Grey CAA and No Sweat should both seek employment law counsel regarding FLSA compliance because it is not clear whether Grey CAA and No Sweat are treated as one employer or two separate employers for FLSA purposes. If Grey CAA and No Sweat are treated as one employer for FLSA purposes, there is a greater likelihood that the two entities will be required to pay overtime.

2. Volunteer Protection Act

The teachers ostensibly are volunteers in the afterschool program, which would entitle them to the shield from liability provided by the Volunteer Protection Act. If, however, the teachers can only work in the weekend program if they volunteer in the afterschool program, their service in the afterschool program may no longer be considered voluntary.

E. Right to Information

Grey CAA was the minority partner in the venture, but that should not preclude Grey CAA from receiving information. Those negotiating on behalf of Grey CAA should have included provisions in the agreement that assured Grey CAA was provided with adequate information, including the right to financial statements and reports describing major decisions and activities. A good case can be made that Grey CAA should have obtained the right to conduct audits. These are not theoretical rights. In one case involving social entrepreneurship, the nonprofit entity that held a minority position alleged that it was not receiving adequate information about the venture.

F. Tax Issues

1. Tax-Exempt Status

Before ever entering into an arrangement involving for-profit entities, a tax-exempt nonprofit should seek the advice of qualified tax counsel. To qualify as a Section 501(c)(3) organization, an entity must be able to demonstrate that its assets are being used for the benefit of its charitable beneficiaries rather than private interests. Anything more than incidental private benefit could result in loss of tax-exempt status. The No Sweat transaction is exactly the type of transaction that could result in loss of tax-exempt status if not property structured. Grey CAA should be able to demonstrate that:

a) The investment furthers its tax-exempt purpose or mission; and

b) It is in control of the day-to-day operations of the joint venture.

The terms of the joint venture provide that the joint venture cannot engage in activities that would jeopardize Grey CAA's tax-exempt status. There should be safe guards in place that assure that the operation of the joint venture in furtherance of Grey CAA's exempt purpose does not become subverted to the interests of the for-profit partners.

At this time, the law is not entirely clear what is and is not permissible. Any tax lawyer looking at this arrangement would recommend that certain changes be made in order to protect Grey CAA's exempt status. Specifically, the lawyer would want Grey CAA to be in control of No Sweat's curriculum and educational activities. This might require that Grey CAA have the right to alter No Sweat's curriculum to better suit the needs of low-income children. Although Delgado and Wilcox might be able to hold a greater than 50% economic interest in the venture, they should not have control over the operational aspects of the venture that further Grey CAA's mission. The parties might use a management contract to assure that Grey CAA has sufficient control. The parties should also be able to demonstrate through concrete evidence that No Sweat is reimbursing Grey CAA at fair market value for joint venture's allocable share of insurance premiums, the rental value of the facilities and the computers, and other direct and overhead expenses that are incurred by Grey CAA, but which benefit No Sweat to some degree.

2. Intermediate Sanctions

The intermediate sanctions are a set of tax rules that require that transactions between a tax-exempt section 501(c)(3) organization and an insider such as a board member, officer, or key employee with substantial influence be priced or valued so as to reflect fair market value. The rules are most often discussed in terms of setting compensation, but they also apply to other transactions, which include property transactions like an investment in a joint venture. Consequently, Grey CAA's decision to enter into the joint venture should be made by independent members of the board of directors and that decision should be documented contemporaneously. Moreover, Grey CAA should have an appraisal or other evidence that it received fair value for its investment.

3. Unrelated Business Income

Whenever a tax-exempt entity enters into a joint venture with an individual or for-profit entity, it must be concerned whether the income it receives from the arrangement constitutes unrelated business income, which is taxable at corporate income tax rates. A good case probably can be made that the No Sweat venture does not produce unrelated business income because the venture benefits low-income individuals on a subsidized basis, but someone must review the issue, particularly if the venture will incur debt.

G. Federal Procurement Law

Recipients of federal grants and CSBG grants generally must comply with the regulations (referred to as circulars) promulgated by the Office of Management and Budget. Circular A-122 sets forth cost principles applicable to nonprofit organizations seeking reimbursement under grants for expenditures. When a cost incurred by a nonprofit benefits both the program funded by the grant and another program, only the portion of the cost attributable to the funded program is eligible for reimbursement. Circular A-122 sets out the rules for making these allocations. These rules would limit the amount of otherwise eligible expenses that Grey CAA could fund through a federal or CSBG grant.

V. Background Material

For additional commentary, review Section III (Conflicts of Interest) of the Background Material accompanying the case studies.

Case 8: Setting the Executive Director's Compensation

I. Context

One of the board's primary functions is setting the executive director's compensation. That compensation must be reported on the agency's annual Form 990, which is filed with the IRS and available for public inspection at http://www.guidestar.org. Whenever a nonprofit runs into trouble, one of the first pieces of information the media examines is the executive director's compensation. State regulators and the IRS both are concerned with and have authority to address excessive compensation. Although setting compensation is the board's responsibility, the executive director also should want a defensible and objective process. Under the federal tax law, the IRS can force the executive director to return any excessive compensation to his employer, plus pay a 25% penalty to the IRS.

II. Facts

KCMC Child Development Corporation (KCMC) was located in Kansas City, Missouri. For its 2002 fiscal year, KCMC had an annual budget in excess of $26 million.[1] Its executive director had been with the agency for close to 25 years when a major controversy erupted over the level of his pay. [2]

A. Executive Director Compensation

According to media accounts, the executive director's compensation, as reported on Form W-2, was $237,000 in 2000, over $310,000 in 2001, and $247,000 in 2002.[3] The completeness of these numbers is open to question. The agency's Form 990 for 2001 reported the executive director had received $343,064 in compensation.[4] According to news accounts, the executive director received a signing bonus, as well as performance and Christmas bonuses. These bonuses presumably were included in the W-2 amounts. KCMC also leased a Mercedes SUV for the executive director's use and incurred expenses to fund his retirement. It is not clear whether these or any other fringe benefits were included in the W-2 amounts. In any event, the U.S. Department of Health and Human Services (HHS) informed KCMC that HHS had issues with the level of compensation paid to the executive director.[5]

B. Comparables

In responding to federal officials regarding the reasonableness of the executive director's compensation, KCMC suggested that its executive director may have actually been underpaid.[6] A public relations firm, in summarizing a letter provided to the federal government by KCMC, said that the executive director had "run a program that has set national standards and that has been

1 Deann Smith and Dan Margolies, *Head Start Fallout Spreads*, KANSAS CITY STAR, Oct. 23, 2003.
2 Dan Margolies and Deann Smith, *Kansas City, Mo. Head Start Executive's Salary is Defended*, KANSAS CITY STAR, Jan. 10, 2004.
3 *Head Start Fallout Spreads* , note 1, *supra*; and Deann Smith and Dan Margolies, *Head Start Fallout Spreads: Congress Notices KC Director's Salary*, KANSAS CITY STAR, Oct. 20, 2003.
4 *Head Start Executive's Salary Defended*, note 2, *supra*.
5 Associated Press, *Feds Investigating Head Start Chief's Pay*, MORNING SUN, Oct. 10, 2003.
6 *Head Start Executive's Salary Defended*, note 2, *supra*.

cited as a national model and that puts him at the higher percentile." The response also indicated that KCMC's board was concerned that some other organization would attempt to recruit its executive director. The executive director was the head of the National Association for the Education of Young Children, making him, in KCMC's words, "a nationally respected professional in early childhood education." According to newspaper reports:

1. The board did not rely on a compensation study when setting the executive director's compensation, but the board did use a study to respond to a federal agency's investigation.

2. The compensation study used to respond to the federal agency examined data from 18 "comparable" agencies, concluding that a fair salary would be $282,360. These agencies included: (i) a United Way; (ii) an art museum; (iii) an organization that operated a psychiatric hospital; and (iii) a YMCA. Top salaries paid by these organizations ranged from $146,000 per year to $226,000.

3. The director of a comparable organization ($18 million annual budget) located in the same state was paid $123,556 in 2001.

4. Public school superintendants in the same locale were paid significantly less than the executive director.[7]

C. An Agency With Problems

KCMC had significant problems in the years immediately preceding the controversy, raising serious questions as to whether the executive director was the stellar performer that his salary implied.

1. A June 30, 2004 audit raised questions as to whether the agency was a going concern because it had current liabilities in excess of its current assets and had recently experienced a significant decrease in its net assets.[8]

2. A federal review resulted in a determination that the agency owed the federal government at least $1.2 million.[9]

3. The agency appears to have significantly overspent its budget.

4. A former KCMC controller pled guilty in February 2002 to participation in a kickback scheme involving renovations to the agency's facilities.[10] The indictment alleged that the controller received over $200,000 in kickbacks.[11] The executive director characterized his relatively high pay level as a reward for responding to the discovery of the kickback scheme.[12]

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7 Laura Scott, *Keep Closer Eye On Head Start Programs; Curb Director's Excessive Pay*, KANSAS CITY STAR, Oct. 15, 2003.

8 Kansas City, Missouri, City Auditor's Office, REVIEW OF AUDITS OF OUTSIDE AGENCIES (March 2006).

9 Deann Smith and Dan Margolies, *Steeped in Debt, Head Start Provider in Kansas City, Mo. Says It Must Bow Out*, KANSAS CITY STAR, Dec. 11, 2004.

10 Dan Margolies, *Head Start Agency Looks to Revamp Board*, KANSAS CITY STAR, Dec. 26, 2003.

11 *Head Start Fallout Spreads*, note 1, *supra*.

12 Deann Smith, *Head Start's Local Agency Settles Case: Current Board Set to Resign*, KANSAS CITY STAR, Apr. 15, 2004.

D. Board Structure

In 2003, KCMC's board had 15 positions, including four vacancies.[13] In a letter sent to several nonprofit institutions in the community, KCMC indicated that the agency's board planned to amend the agency's bylaws to eliminate open-ended terms. Directors would be limited to two consecutive three-year terms.

E. Lawyer's Viewpoint

A lawyer associated with KCMC characterized the federal government's efforts to recoup some of the executive director's salary as the efforts of right-wing opponents to Head Start.[14]

III. Discussion Questions

The following questions are offered for discussion:

A. What criteria should be used by the board in setting an executive director's compensation?

B. When examining comparables, should the universe of nonprofits be limited to nonprofits:

1. Located in the same community?

2. Receiving grant money from the same sources?

3. Can for-profit entities be included?

C. How should the executive director's longevity factor into the analysis?

D. Should the agency set salary at a level designed to prevent another organization from luring the executive director with a more lucrative offer?

E. Should the executive director be held accountable if there is a major fraud on his watch?

13 *Head Start Agency Looks to Revamp Board*, note 18, *supra*.
14 Editorial, *Board Needs Reality Check*, KANSAS CITY BUSINESS JOURNAL, Jan. 30, 2004.

IV. One Suggested Solution

A. Basics

In setting the executive director's compensation, the board should rely on a clearly-defined deliberative process. The board should consider using a compensation committee to undertake the analytical work, with the final decision reserved to the full board. Those involved in the process should be independent of the executive director. The board should rely on comparables, as well as performance reviews.

B. Head Start Limitations

1. Policies

Under the Head Start Act, each Head Start agency must:

a) Establish specific standards governing salaries, salary increases, travel and per diem allowances, and other employee benefits.

b) Assure that only persons capable of discharging their duties with competence and integrity are employed and that employees are promoted or advanced under impartial procedures calculated to improve agency performance and effectiveness.

c) Guard against personal or financial conflicts of interest.

2. Salary Cap

No Federal funds may be used to pay any part of the compensation of an individual employed by a Head Start agency, if such compensation, including non-Federal funds, exceeds an amount equal to the rate payable for level II of the Executive Schedule under section 5313 of title 5 of the United States Code.

a) The Current Level

The Executive Schedule is periodically adjusted. The level II rate was last reset in January 2009 to $177,000.

b) Total Compensation

The salary cap applies to total compensation paid to an employee. That means that no Federal funds can be used to pay an employee's salary if the employee's total salary exceeds the cap. For example, if an executive director was paid $200,000 a year, with $190,000 of his salary funded by private sources, the other $10,000 in salary could not be funded with Head Start funds.

c) Compensation

The term compensation includes salary, bonuses, periodic payments, severance pay, the value of any vacation time, the value of a compensatory or paid leave benefit and the fair market value of any employee perquisite or benefit, but excludes any Head Start agency expenditure for health, medical, life insurance, disability, retirement, or any other employee welfare or pension benefits.

C. Intermediate Sanctions

The intermediate sanctions are a comprehensive set of tax rules designed to assure that compensation paid to key employees and other insiders reflects market-rate compensation. If the IRS determines that the compensation is excessive, it can force the recipient to return the excess to the exempt organization and assess an excise tax equal to 25% of the excess on the recipient. The centerpiece of this regime is a rebuttable presumption that compensation is reasonable if certain procedures are adhered to when setting the compensation. Specifically, the organization must demonstrate that (i) the compensation arrangement was approved in advance by the board of directors (or a committee thereof); (ii) such board (or committee) was comprised entirely of individuals who did not have conflicts of interest; (iii) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the compensation arrangement; and (iv) such board (or committee) adequately documented the basis for its determination concurrently with the decision. The rules contemplate otherwise conflicted individuals recusing themselves from the process.

1. Consultants

Some boards seek the advice of an outside consultant when setting the executive director's compensation. This is appropriate, but the consultant must be independent. That means that the board should select the consultant. It also means that there should be no hidden conflicts. For example, the consultant should not be providing other consulting services to the CAA (e.g., advising on employee benefits) if the executive director controls the selection of the consultant.

2. Comparables

The executive director's compensation should take comparables into account. Selecting comparables can be tricky. KCMC chose to include the compensation paid to the executive director of an art museum, a YMCA, and a United Way in its survey of comparables.

3. Proper Focus

a) Focus on the Organization

Some will argue that a CAA cannot use the amount of compensation paid to an executive director of a local United Way or art museum as comparables because a CAA is an operating social services agency, while a museum is engaged in an entirely different activities and a United Way is largely a grantmaking organization. Those who make this argument believe that the comparables should be limited to organizations engaged in similar activities. In their view, the decision to look to another sector for compensation comparables may be a sign that the organization is selecting organizations to justify a predetermined level of compensation. According to advocates for this viewpoint, relying on comparables from organizations engaged in different activities is particularly troublesome if the organizations selected draw on a entirely different labor pool.

b) Focus on Skills

Others argue that the focus when selecting comparables should be on positions that require similar skills regardless of whether the organizations are engaged in similar activities. Under this view, the skills required of a good executive director or CFO are the same regardless of whether the organization is an art museum, United Way, YMCA, or zoo. An executive director, for example, must be able to work with a board, supervise and guide program heads, and listen to those who rely on the organization's services. A CFO must be able to establish in-

ternal controls, manage a staff of accountants, communicate with the executive director and board about financial matters, and work with auditors. People who hold these higher level positions require many of the same skills regardless of the organization's mission or specific activities. Advocates for this position might point to Bob Nardeli, who has headed up both Chrysler and Home Depot. He also was held a top-level executive post at General Electric. Those companies are engaged in entirely different activities, yet Nardeli's executive talents were readily transferable.

4. Examples

a) Looking to a YMCA for Comparables

Like CAAs, some YMCAs provide a wide range of social services to people within a community. Some YMCAs operate programs for the elderly, day care centers, and after-school programs for at-risk youth. These YMCAs may rely heavily on the government grants for funding. Under these circumstances, a CAA might appropriately look to the amount paid to the executive director of a local YMCA as a comparable. On the other hand, some YMCA's function as athletic clubs, relying heavily on membership dues for their revenue. In these cases, a CAA may have more difficulty treating the compensation paid to the executive director of the local YMCA as a comparable. The executive director may have specialized skills required to run an athletic club that place him in a different labor market.

b) Looking to an Art Museum for Comparables

A CAA might look to a local art museum for comparables. This might be appropriate when setting the salary of a CFO or the head of HR. The skills possessed by these individuals are easily transferable to organizations in different sectors.

A CAA should be more reticent when it comes to relying on the compensation paid to the executive director of an art museum as a useful comparable. While a CAA executive director requires many of the same management skills as the head of an art museum, there may be significant differences between the two. First, and foremost, the museum may require someone with advanced education in the arts or art history. That may limit the museum to a specialized labor market. Both the executive director of a museum and a CAA require fundraising skills. Fundraising in the arts relies heavily on entertaining and personal relationships, but fundraising for CAAs requires grant writing and administration skills. These differences undercut reliance by a CAA on compensation data sourced to a museum or other cultural institution.

5. Looking to other CAAs

Those assembling the data must be careful even when selecting CAAs for comparison. A CAA located in an urban area probably is not comparable to one located in a rural community. Moreover, an agency with one or two programs probably should not view agencies with ten or twelve programs as comparable.

6. Conclusion with Respect to Comparables

There is no one rule that can be used to determine whether a CAA can characterize positions with other organizations as comparable ones. The board must consider all the facts, examining organizational context, the labor market, and the position being evaluated and its duties. In the end, the old adage "To thine own self be true" applies. If a board makes a good faith effort

to examine comparables that truly are comparable, it should have a supportable position. If the board simply is supporting a predetermined decision with nothing more than dollar amounts, it should not be surprised if the IRS, a state regulator, or a government funder reject the data.

D. Lake Wobegon Syndrome

According to Garrison Keillor, in Lake Wobegon, "the women are strong, the men are good looking, and all the children are above average." That adage doesn't apply just to those living in Lake Wobegon. Many boards and compensation committees routinely peg an executive's compensation at the 70% percentile when examining a series of comparables. Boards should recognize that there are legitimate reasons for pegging an executive director at the 30% or 40% levels. For example, a new hire may be a perfect fit on paper, but may lack any relevant experience.

E. Bonuses

Any bonus should be paid for demonstrable performance. It should be tied to pre-defined benchmarks. A bonus should never be paid simply because there is extra money in the budget.

F. Tally Sheets

Each board member should be provided with a tally sheet before being asked to approve the executive director's compensation package. A tally sheet is a one- or two-page summary of the executive director's compensation, listing the base amount of pay (cash), fringe benefits, perquisites, company-financed contributions to qualified plans, deferred compensation, and expense reimbursement plan. It provides an overall sense of the executive director's total compensation.

V. Background Material

For additional commentary, review Section I (Setting Compensation) and Section II (Incentive Compensation) of the Background Material accompanying the case studies.

Case 11: Developing and Maintaining Communication Channels

I. Facts

Case 2 considered the potential problems posed by the powerful board chairman. In that case, the chairman was Archie Brooks and the agency was the Central Iowa Employment and Training Consortium (CIETC). Take a few minutes to review that case if you don't recall the core facts.

A. Whistleblowers

CIETC's board might have been able to rectify CIETC's problems had it heard from the whistleblowers who attempted to alert various officials, including regulators and elected officials. Virtually all those who received alerts were slow to respond.

B. Initial Reports

In April 2006, an anonymous former CIETC employee talked with the media about what she had seen while working in CIETC's payroll department. [1] Recall that the scandal centered on excessive compensation, so this employee had a bird's-eye view. She requested anonymity out of fear over retaliation.

The former employee told KCCI 8 News that the misuse of public funds had been going on for years. She noticed several checks for $3,000 made out to top executives, causing her to copy them and report the matter to the FBI.

C. Investigatory Report

One of the more prominent whistleblowers was Kelly Taylor, a budget analyst with Iowa Workforce Development (IWD), a state agency that disbursed grant money to CIETC.[2] There are allegations that Jane Barto, IWD's deputy director, and Ramona Cunningham, CIETC's CEO, had a close personal relationship.[3]

During the course of an investigatory interview by state investigators,[4] Taylor identified the following five concerns: (1) the salaries and bonuses for CIETC executives; (2) the changes by an IWD employee to the way the budget analysts address issues in monitoring reports; (3) hiring procedures at IWD; (4) the treatment of Taylor by IWD management; and (5) employees on CIETC's payroll who performed work for IWD, not CIETC.[5]

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1 *Former CIETC Works Says Payroll Abuses Happened for Years: Worker Says Those at Top Knew of Misspent Funds*, KCCI 8 News, Apr. 8, 2004.

2 WHOtv.com, *Brooks Reacts to CIETC Memo*, May 22, 2006; *CIETC Scandal: The Week in Review*, Des Moines Register, Apr. 7, 2006; and Jonathan Roos, Jason Clayworth, and Clark Kauffman, *Audit Fallout Builds Pressure on Workforce Officials*, Des Moines Register, Apr. 5, 2006.

3 *CIETC Scandal: The Week in Review*, Des Moines Register, Apr. 7, 2006; and Clark Kauffman and Jonathan Roos, *Top Officials Quit Over State Job-Training Pay Controversy*, Des Moines Register, Apr. 6, 2006.

4 Summaries of a number of interviews by state investigators are available the *Des Moines Register's* Web site. Regrettably the summaries do not indicate who conducted the interviews. The *Register* identifies the summaries as government investigatory documents, but is less than clear in identifying the specific government unit that conducted the investigation.

5 Investigation Report Summary—Iowa Workforce Development—Summary of Interview with Kelly Thomas (Apr.

The State of Iowa conducted an extensive investigation into the scandal. Summaries of the interviews paint a detailed, but confusing picture of the contacts between the various participants.[6] Some of the interviews suggest or allege that there were attempts to thwart efforts to surface alleged wrongdoing. The Des Moines Register, in detailing the scandal, reported,

> "Jane Barto called our office in the region and requested that (Workforce Development) be allowed to investigate the matter," said Mason Bishop, the U.S. Department of Labor's deputy assistant secretary for employment and training. "And she assured our staff there was no indication of criminal behavior."
>
> Barto denied any attempt to discourage an investigation into CIETC.
>
> But the alleged call to federal officials indicates that Barto was attempting to overrule her agency's financial experts as they called for a federal investigation.[7]

The Register then details contacts by Kelly Taylor, the whistleblower working as an IWD budget analyst, with the Chicago office of the Department of Labor, reports by Taylor to his superior, allegations that Barto removed Taylor from the investigation, and allegations that IWD officials then tried to head off a federal investigation.

One whistleblower sent letters detailing CIETC's problems to Iowa's governor, a U.S. Senator and a member of the U.S. House of Representatives.[8] The whistleblower also indicated she mailed letters to several CIETC board members. There is some indication in the Register's reporting that the anonymous nature of the letters may have resulted in the letters receiving less attention than they might otherwise have received. According to the Register, the whistleblower who sent the anonymous letters was placed on administrative leave about two months after sending the letters.

II. Discussion Questions

The following questions are offered for discussion:

A. Although there is some indication that at least one whistleblower sent letters to certain members of CIETC's board, the whistleblowers appear to have focused their efforts on contacting people outside of CIETC. Why might that be the case?

B. If you were a high level official in an organization, would you be more inclined to respond to an anonymous letter than one from an identified individual?

C. What steps might CIETC's board have taken to encourage whistleblowers to report alleged wrongdoing to CIETC's board rather than to outsiders?

7, 2006).

6 See note 5, *supra*.

7 Clark Kauffman and Jonathan Roos, *Top Officials Quit Over State Job-Training Pay Controversy*, Des Moines Register, Apr. 6, 2006.

8 Jason Clayworth, *Ex-Worker Tells of '04 CIETC Alert*, Des Moines Register, Apr. 20, 2006.

D. What can a board do to prevent an executive director from hiding problems or wrongdoing from the board?

III. One Suggested Solution

A. The Dilemma

The board must rely on people within the organization to provide it with information about problems facing the CAA, but if senior management is the cause of those problems, lower-level employees will be reluctant to bring the problems to the attention of supervisors. To assure that the board receives vital information, the board must develop clear lines of communication with all employees so that employees know where to report their concerns. It also must make sure employees are comfortable in doing so.

B. Reasons for Silence

Lower level employees may decide to remain silent for a variety of reasons. First, and foremost, many fear retaliation. Second, an employee may not make a report because he is unsure whom to contact. Third, employees may have detected that the board is dysfunctional, leading to the conclusion that there will no response so why take the risk? Fourth, employees who are particularly disturbed by the circumstances may decide that the most expedient action is to seek employment elsewhere.

C. The Approach Taken by CIETC's Whistleblowers was Telling

CIETC's whistleblowers decided to report their concerns, but mostly to those outside of CIETC. This strongly suggests that CIETC's board was ineffective and nonresponsive. Brooks' comments to the media support that view. It also appears from the media accounts and interviews that the whistleblowers believed CIETC's senior management would not respond. That should come as no surprise given the fact that senior managers were the recipients of the compensation that caused the concerns.

D. Anonymity

Open-minded managers and boards are more likely to respond to complaints by persons who are willing to identify themselves. This is only natural. A number of CIETC's whistleblowers reported anonymously to outsiders. Not surprisingly, those outsiders were less responsive than they might otherwise have been had the whistleblowers identified themselves. People want the context that comes with knowing who is raising the complaint before taking action.

Although anonymity is less preferable from the board's standpoint, it may be necessary if the board wants information. Even when anonymity is assured, some employees may be highly suspicious of those assurances. Whatever the assurances, the CAA should be careful to point out that it cannot guarantee anonymity if formal legal proceedings result from the complaint. Although the CAA may intend to keep someone's identity confidential and certainly should do so if it has made assurances, the CAA may be required by law enforcement officials, judicial proceedings, or even funders, to make disclosures.

E. Organizational Culture

Obviously adopting and then publicizing a whistleblower policy is a step toward establishing an open-door policy. In truth, however, a piece of paper is not going to result in reports if the employees perceive senior management as Gestapo-like in their tactics. Long before the board adopts a formal whistleblower policy, it has established a de facto one as result of who it hires and

the control it exerts over employment practices and policies. If the board has shown that it is responsive to employees, it is much more likely to receive vital information from employees who are concerned about the organization, particularly if there are clear channels for communicating the information. The board shows that concern not in just how it responds to a whistleblower, but how it responds to employee questions and proposals in general.

F. Multiple Channels

CAAs should consider instituting multiple reporting channels for whistleblowers. For example, concerns over financial fraud and mismanagement might be directed to the board's audit committee, while concerns over employment practices might be directed to someone in the HR department or the board's compensation or personnel committee. Each CAA will have to consider its unique circumstances to determine what channels will work best for it.

G. Third Party Reporting Hotlines

A number of private companies have recognized the need for independent third party reporting. Some do offer services directed at nonprofits, but most focus on larger companies that have need for independent reporting because of the federal Sarbanes-Oxley Act (Section 301 requires anonymous reporting procedures, but this requirement only applies to publicly-traded companies subject to the Act) and concerns over the Federal Sentencing Guidelines.[9]

H. Solving Problems Before They Become Expensive

Whistleblowers who become frustrated may decide to raise their concerns outside of the organization, as was true in the case of one CIETC whistleblower. This can prove embarrassing if the whistleblower seeks the media's help, or expensive if the whistleblower contacts a lawyer. Section 3729 of Title 31 to the United States Code imposes liability on persons and organizations who knowingly present to the United States false or fraudulent claims for payment or approval. Section 3730 then goes onto provide for a private right of action by qui tams (private individuals that include a nonprofit's employees), which permits these individuals to participate in the recovery received by the government. A nonprofit may assume its employees are unlikely to file a suit. That may be true, but a Google search of "Federal False Claims Act" or qui tam returns results that point to a very active plaintiff's bar. Many states have adopted analogues to the Federal False Claims Act. A CAA that provides its employees with a clear avenue to bring wrongdoing to the attention of the board may be able to avoid expensive outside involvement by an aggressive lawyer.

IV. Background Material

For additional commentary, review Section IV (Whistleblowers).

9 Chapter 8 of the Federal Sentencing Guidelines (2004)