Feature Report on Charities Law

Surviving Stormy Seas:
Governance in Rocky Times

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Peter Broder

Noted author and New York Times columnist Thomas Friedman, commenting recently on the possible takeover of U.S.-based Sovereign Bancorp Inc. by the Spanish Banco Santander SA, observed that the Board of Directors of the European financial institution meets twice a week to review the risk of the bank's credit portfolio. As a result, it avoided much of the turmoil in worldwide markets and is positioned to buy the American company, which had been devastated by the economic crisis.

The lesson Friedman drew from this was that, at heart, all regulation is local, and increased government rules can never be a wholly satisfactory substitute for prudent grassroots oversight.

Further evidence, if any was needed, for Friedman's position was provided a few days later by a short item in *The Globe and Mail*. It reported that a former Canadian director of American International Group – last September, the beneficiary of a huge U.S. government bailout – who enquired about a potential conflict between a late afternoon meeting and a scheduled AIG Board meeting, was informed that the Board meeting would be finished well before noon, so there was no need to worry about an overlap.

The poor performance of AIG's Board later came under fire from, among others, Columbia University corporate governance guru John Coffee.

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The charitable and non-profit world has its own share of stories about the consequences of disengaged or hands-off boards. These situations often don't make the headlines because poor oversight of a voluntary sector organization does not result in a meltdown of the share price. It does, however, often have a potentially devastating impact on a group's effectiveness and the quality of the programs or services it is able to offer.

When a problem does come to light in the press, or when changes to the regulatory structure for charities or non-profits are considered, calls for more interventionist government regulation are routine. Aside from the challenges of imposing rules that do not burden groups with excessive administrative costs and stifle innovation, jurisdictional limitations make government oversight of board conduct a tricky issue in Canada.

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While the U.S. counterpart of the Charities Directorate, the Internal Revenue Service Exempt Organizations Division, has recently released governance guidelines for charities, this move has been criticized as beyond its authority, and in Canada there has been no move to introduce policies or guidance in a similar vein.

Board roles and responsibilities in the voluntary sector vary widely depending on the evolution and resources of an organization. Often the governance model to which directors and staff aspire is what is commonly known as a "policy board." Generally, this is a structure in which responsibility over the group's routine operations is delegated to an Executive Director (or Chief Executive Officer). The board takes responsibility for establishing a policy framework within which the senior staff person exercises his or her decision-making authority. Under this type of structure the board is also responsible for monitoring organizational performance and for setting or changing the group's broad direction.

Enthusiasm for delegating authority over a charity or non-profit's daily operations is understandable from the perspective of both staff and directors. Prior to the emergence of the policy board model, many organizations were plagued by board members who second-guessed or usurped senior management, demoralizing executive staff and leaving more junior personnel confused about who was in charge. Time-pressed and mission-driven board members were also often happy to be relieved of the need to become versed in organizational minutiae.

Although programs offering formal training for directors have become increasingly available, the norm is still for charitable or not-for-profit directors to serve with little or no training. Without adequate training, and a solid understanding of their responsibilities and authority, directors often shy away from questioning or challenging the information they receive or the proposed courses of action.

Experience since the emergence of the policy board model in Canada, however, suggests that the drawbacks and risks of this type of governance are not well understood. The problems associated with lax board practices sometimes rival those associated with excessive interference in the harm they cause to organizations.

As a starting point, the compatibility of the broad delegation of responsibility to staff by boards is open to legal challenge. Although the matter has not been extensively litigated with respect to charities, both federal and provincial Canadian law impose strict constraints on the latitude of trustees to deal with assets in their care. This means that charity boards may not as freely delegate powers to staff as they might like. Those that do transfer powers wholesale to staff may be in breach of trust and breaking the law.

Leaving aside that consideration, common shortcomings of the policy board model include:

- an inadequate reporting system to allow boards to assess performance;
- an incomplete or ineffective framework to constraint the authority of senior management;
- lack of capacity or inclination among directors to interpret information they receive; and
- boards being misled or kept ignorant of key information.

Let's look at each of these in turn.

The appropriate mechanisms and metrics to evaluate organizational performance vary widely depending on a group's mandate and character. Without a blueprint for the tools to judge the organization's success, many boards don't effectively fulfil this role and look to top line financial data as the proxy for organizational health or achieving the mission. As in the for-profit sector, the short term economic success of charities or not-for-profit groups can belie longer term organizational weakness.

Beyond financial statements, often metrics are unduly focused on easily measurable levels of activity, rather than on substantive progress in program areas. So the assessment is framed as "Did we have more participants?", rather than "How successful was our program in dealing with the issues faced by those who participated in it?" Applying the proper metrics is often difficult enough in the face of funder reporting protocols heavily reliant on numbers and journalists with fleeting attention spans. The use of a policy board model – which usually discourages probing questions about programming – only redoubles the challenge. The brunt

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of any shortcomings in this type of oversight usually falls directly on a charity's beneficiaries or a not-for-profit organization's stakeholders.

Having delegated responsibility to staff, many organizations do not follow through to ensure that the necessary checks and balances are in place so there are adequate constraints on executive authority. This can be particularly difficult where there is a single senior manager, rather than a management team. The norm in such circumstances is for all information to flow through the senior executive, thus providing limited opportunity to verify that he or she is operating within bounds.

Many organizations move to a policy board model without including executive limitations in the employment contract of the senior executive or without having in place policies on, for example, nepotism, whistle-blowing, or conflict-of-interest. This is simply bad practice and leaves groups vulnerable to abuses. In its new governance guidelines, the U.S. Internal Revenue Service specifically recommended that charities establish a process to protect whistle-blowers from reprisal where they brought wrong-doing to the attention of the governing body.

Even when a good reporting system or an effective framework of limitations are in place, board members often do not have the capacity or inclination to hold staff accountable. Since many voluntary sector board members are unpaid, and are frequently recruited for their affinity with the cause rather than their management expertise, this may be understandable.

Although programs offering formal training for directors have become increasingly available, the norm is still for charitable or not-for-profit directors to serve with little or no training. Without adequate training, and a solid understanding of their responsibilities and authority, directors often shy away from questioning or challenging the information they receive or the proposed courses of action. It goes without saying that rubber stamp boards are no more appropriate for charitable or not-for-profit boards than they are for for-profit groups.

Finally, there is the issue of senior executives either misleading or withholding information from boards to protect their reputations, and sometimes their jobs. While there are no statistics on this, there is anecdotal evidence that such practices occur with unhappy frequency.

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The average executive director (E.D.) in a contemporary Canadian organization, particularly in a small charity or not-for-profit, is overwhelmed with responsibilities. Even the best intentioned E.D. may be reluctant to bring problems to the attention of his or her board because it may cast the E.D.'s management of the organization in an unfavourable light. And, given the vagaries of fundraising and funders, it is all too easy for an E.D. to mistakenly believe that the financial stresses facing an organization today can be overcome tomorrow, and be less than forthright with the board about how sustainable the operations are. Informing a board of these kinds of issues may be seen by an E.D. as just adding another headache compounding the problems that he or she must deal with. In cases of questionable conduct, the incentive to dissemble or withhold information is even greater.

Because of the privileged relationship to the board enjoyed by executive directors in most circumstances where the policy board model is in use, the executive director has wide latitude to control what information is seen by the board. Given this and the other dynamics at play, the flow of information is not always as complete as might be desired.

It is not uncommon for boards operating under the policy governance model to discover that they have been missing critical pieces of information or have been misled – usually when they transition to a new executive director. Sometimes the damage that has been done is irreparable, and there are even cases where organizations go under because boards have not had adequate information to head off financial or program meltdowns.

In the U.S., in response to the bailouts of businesses and financial institutions necessitated by their reckless conduct, there has understandably been a chorus of calls for government to intervene in the running of these enterprises. This echoes the refrain heard, from time to time, for greater government scrutiny of voluntary sector organizations in light of perceived abuses, as does the riposte that such heavy-handed regulation invariably creates bureaucracy and stifles innovation.

Canada's voluntary sector, and charities in particular, are already saddled with enough government constraints on their conduct. Without better implementation or – in my view – major re-thinking of the policy board model, instances of organizational failures will only increase. The danger of this is even greater as tight economic conditions leave sector organizations with less and less room for error. If such failures occur, the pressure for more command and control regulation will likewise rebound.

A more helpful approach in this economic climate would be to win for sector

organizations the scope to be more nimble and innovative than they can be under the existing regulatory regime. Easing rules around social enterprise and business activity, for example, would give registered charities more opportunity to finance their activities through earned income at a time when government funding and donations will both be under stress. But that kind of freeing up can only happen if we prove Friedman's point that model governance is not only local, but also incontrovertibly effective. There are a few for-profit firms that, if they had it to do over again, would probably like to do the same.

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