

# Managing Risk: Board Oversight of Foundation Investments

By Andras Kosaras and Karen Green

*The Madoff Ponzi scheme scandal added the final exclamation point to the most disastrous period for foundation investments in memory. The stock market dropped in 2008 by almost 40%. At their nadir in March 2009, foundation assets had dropped by anywhere from 25% to 60%, forcing most foundations to cut back sharply on their grantmaking, and some to outright terminate and dissolve, having lost all of their assets. The Madoff scandal had a related and possibly more detrimental long-term consequence—it caused considerable damage to the reputations of those foundations that invested through Madoff or through feeder funds to Madoff.*

In the post-Madoff era, the foundation and nonprofit sector continues to struggle with how to invest philanthropic assets most appropriately, and how to ensure that boards and staff are managing investments prudently. This issue of *Passages* looks at the critical role of governance and the responsibilities of family foundation boards for prudent investment practices.

## **HOW WE GOT HERE: A BRIEF HISTORY OF FIDUCIARY RESPONSIBILITY**

### **The Changing Landscape of Prudent Investment Management**

The laws governing the management responsibility of foundation fiduciaries with respect to investment decisions have changed a great deal over time.

Historically, laws significantly restricted the ability of charitable institutions to pursue diverse investment strategies. Foundation law evaluated investment performance on individual investment decisions, rather than on the performance of the portfolio as a whole, and emphasized production of income and preservation of capital over growth, while also prohibiting foundation managers from delegating investment decisions to third-parties. In some cases, foundation managers were limited to making investments in securities (primarily fixed-income securities) appearing on “legal lists.”

Developments in financial management and the markets, and corresponding changes in the law, incorporated a new concept of fiduciary responsibility that



focused on investing for “total return.” This investment strategy not only takes into account interest and dividends, as well as capital appreciation, when measuring investment returns, but also evaluates investment performance based on the foundation’s entire portfolio, rather than the returns or losses of individual investments.

As the markets and financial instruments change, foundation managers must understand how their fiduciary responsibilities apply to a changing landscape. In recent times, a growing number of foundations and charities have increased their exposure to alternative investments, including hedge funds and other forms of investments. These alternative investments were intended to diversify an investment portfolio by including assets that were designed to have a low correlation with the rest of the foundation’s portfolio. They also had the lure of significant returns. That was the theory, at least, until 2008 —when the value of nearly all investments correlated in the same direction: downwards.

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The considerable asset losses in 2008 and the early part of 2009 led to renewed focus on potential actions that state and federal regulators could take against foundation managers to hold them accountable for investment decisions. This oversight responsibility, however, is not new. The IRS and state regulators have always had the authority to investigate whether a foundation is managing its investments prudently. Although the IRS has generally not focused on a foundation’s investment management in the recent past, state charity regulators, including the attorneys general, have increased their enforcement of state laws with respect to investment management in recent years.

**Every foundation donor, trustee and staff member should remember that the buck stops with the board.**

Cases of improper governance at nonprofits and private foundations have percolated over the years in states such as Pennsylvania, California and Massachusetts, among many others. One interesting example of questionable fiduciary practices came to light in New Hampshire in 2003 and 2004 at an endowed private school, the St. Paul’s School, when the state attorney general noticed that the school had very high asset allocations in alternative investments. The school—with an endowment of more than \$360 million—had up to 70% of its assets invested in alternative investments, and this led the state to ask further questions. Eventually, the attorney general reviewed the compensation practices at the school and of the board’s governance in general. Harold Janeway, an investment banker who served as one of the state’s outside experts on the case, said in a 2006 *Vanity Fair* article about the school that, “It wasn’t so much what they were doing, but *the way* they were doing it.”

Critics and watchdogs have claimed that one of the main reasons some foundations experienced such devastating losses in late 2008 and early 2009 is because boards were not paying attention. For instance, Senator Charles Grassley, chairman of the Senate Finance Committee, which has oversight of the IRS for enforcing laws regulating taxes on nonprofit organizations, noted that “Those who invested with Madoff appear to have boards that may have looked the other way in return for the promise of high earnings.” (Source: “Grassley Outlines Goals for Charitable Governance, Transparency” Buchanan Ingersoll & Rooney, Washington, D.C., Tuesday, March 10, 2009.)

Every foundation donor, trustee and staff member should remember that the buck stops with the board. This is true both for small, unstaffed foundations, as well as for larger foundations that

are fully staffed with a dedicated finance and investment department. Regardless of the extent to which foundation boards have chosen to delegate investment management to staff and outside professionals, at the end of the day, regulators and overseers will always come back to the board and ask whether the board is doing its job in governing the organization.

With this background on investments, we turn now to a look at the context for other core governance issues facing foundations.

### **Board Fiduciary Duties: Duty of Care and Duty of Loyalty**

Good financial governance encompasses more than just managing a foundation's investments. Family foundation boards must set appropriate compensation and benefits, conduct annual reviews of their Form 990-PF return, regularly review financial statements, and develop strong conflict of interest and document retention policies—and more.

When looking at governance concerns, it's helpful to understand who's involved in overseeing and regulating family foundations in particular, and the nonprofit sector, generally. And, based on these concerns, what do foundations need to know?

The recent spotlight on foundation and nonprofit governance began more than five years ago on the heels of the Enron scandal. The Enron case was really the beginning of regulators' renewed focus on accountability, transparency and governance. Here are prominent board lapses cited:

- Board and management oversight were impaired by conflicts of interest,
- Board controls were inadequate and inappropriately implemented, and
- Board audit and compliance reviews were cursory and ineffective.

At the root of it all, the Enron case illustrates a situation where the board simply didn't *understand* the significance of the information that came before it.

In response, Congress passed Sarbanes-Oxley. And although the vast majority of that law did not apply to nonprofits, two important elements did:

- Requirements for document retention and
- Requirements protecting whistle blowers.

Some philanthropy observers feel that these two requirements were an early indicator that the federal government has determined that requirements applied to one sector, in this case the for-profit sector, are often good for, or transferable to, other sectors, like the nonprofit and foundation sector.

### **Sarbanes Oxley in 200 Words or Less**

The Sarbanes-Oxley Act was signed into law on July 30, 2002. Passed in response to the corporate and accounting scandals of Enron, Tyco, and others of 2001 and 2002, the law requires that publicly traded companies adhere to new governance standards that broaden board members' roles in overseeing financial transactions and auditing procedures.

While most provisions of the Act apply only to publicly traded corporations, the passage of the bill was a wake-up call to the nonprofit community as well. Indeed, several state legislatures have already passed or are considering legislation containing elements of the Sarbanes-Oxley Act to be applied to nonprofit organizations. In many instances, nonprofit organizations have adopted policies and altered governance practices in response to the Act.

Nonprofit leaders should carefully review the provisions of Sarbanes-Oxley and state laws to determine whether their organizations ought to voluntarily adopt governance best practices, even if not mandated by law.

(Adapted from *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations*, co-published by BoardSource and the Independent Sector and available in full at: [http://www.independentsector.org/sarbanes\\_oxley](http://www.independentsector.org/sarbanes_oxley).)

**Governance must be embedded in an organization's policies and within an organization's culture.**

The for-profit scandals led the media to wonder if similar problems were occurring in the nonprofit sector. As a consequence, a flurry of nonprofit scandals has been uncovered by investigative journalists over the past several years. Many of these questionable situations involved inadequate oversight by boards, and resulted in things like private benefits and excess compensation. As a result of the availability of IRS Forms 990 and 990-PF on GuideStar, examples of high compensation can be easily unearthed by a simple review of a foundation's annual information return (a good reason for the board, or appropriate board committee, to review the 990-PF annually before it is submitted). In general, reporters focused on exposing instances where foundations had reported high levels of compensation relative to grants made or to the foundation's total assets.

The media's coverage of extreme examples of nonprofit and foundation compensation practices make it easy for the state attorneys general, who have oversight for foundation compliance at the state level, to begin investigating these organizations.

**Accountability: Who's Watching?**

There are a number of influential stakeholders keeping an eye on the governance and investment practices of foundations, including:

- **State Attorneys General:** State attorneys general enforce state laws that regulate charitable organizations, including the fiduciary responsibilities of foundation managers.

- **Media:** When it comes to the press, good news is often “no news,” and as a result many investigative reporters seek to highlight bad apples.
- **IRS:** The IRS is charged with enforcing compliance with the federal tax code. In recent years, the IRS has increasingly emphasized that, in their view, good governance leads to tax compliance. In 2005, the IRS issued 2,000 so called soft-audit letters where they inquired about compensation and about foundations' independent contractors, which was a way ferreting out conflicts of interest and related-party transactions. Eight hundred of those 2,000 soft-audit letters resulted in actual audits. In 2009, the IRS published a “governance check sheet” that will be used during every IRS examination of section 501(c)(3) public charities to collect information about the governance practices of these organizations.
- **Senate Finance Committee, House Ways and Means Committee, and the Joint Committee on Taxation:** The Senate Finance Committee and the House Ways and Means Committee are the Congressional tax writing committees. The Joint Committee on Taxation assists these Congressional committees with analyzing and writing tax legislation which includes tax exemptions.
- **Organized Philanthropy:** organizations serving donors, such as the National Center for Family Philanthropy, the Council on Foundations, Independent Sector and the Regional Associations of Grantmakers have a dual motivation in accountability and standard settings and the educational work that they do. First, and most importantly, they develop and encourage adoption of best practices. Second, they advocate for the importance of self-regulation as a way to complement, as well as to minimize the need for, additional government regulation.

## FIDUCIARY DUTIES OF BOARDS: DUTY OF CARE AND DUTY OF LOYALTY

Two overarching requirements define the fiduciary duties of board members and officers of nonprofit organizations and foundations: the *duty of care* and the *duty of loyalty*.

The *duty of care* requires board members to run an organization and to make decisions about the affairs of the organization with the care that an ordinarily prudent person in a like position would make. This duty requires that members of the board be consistently and actively involved in the governance of the organization.

This does not mean that board members have to do everything themselves. The law allows fiduciaries to delegate day-to-day management and certain governance functions to outside professionals or staff, and to rely on the expert opinion of others. For example, a foundation's board may hire expert investment managers to invest the foundation's assets. The board may not, however, delegate its oversight responsibility in managing the foundation's assets. It must review how the investment manager is carrying out his or her task. These issues are discussed in more detail below.

**If family members are being paid to manage the investments, the board must be very careful about how this conflict of interest is handled.**

The *duty of loyalty* requires that board members make decisions that are in the best interest of the organization. This duty is most relevant when reviewing possible conflicts of interest and

**Boards have a fiduciary duty to investigate and provide oversight over individuals tasked with investment functions.**

related-party transactions. The concept of conflict of interest and the duty of loyalty are very important for family foundations, particularly when the foundation is not staffed and board members are involved in managing the investments of the organization. If family members are being paid to manage the investments, the board must be very careful about how this conflict of interest is handled.

When discussing the fiduciary duties of board members, it is sometimes helpful to refer to a third duty, the *duty of obedience*, which can be thought of as part of the duty of loyalty. This duty generally requires board members to continually seek to fulfill the purposes of the organization. This is especially important when the founding donor has placed restrictions on the purposes of an organization.

Complying with fiduciary duties as described above does not mean that board members will be punished if they make reasonable decisions that do not turn out well in hindsight. Following what is known as the "business judgment rule," a court will generally not second-guess decisions and penalize fiduciaries who made them so long as they were based on a *reasonably informed decision* and made in good faith in the best interest of the organization.

## INDIVIDUAL BOARD MEMBER LIABILITY: FEDERAL AND STATE RULES FOR PRIVATE FOUNDATIONS

Board members have real and significant personal liability with respect to the management of a foundation. It is true that, in some cases, federal and state volunteer protection statutes may protect board members against personal liability if they serve as volunteers without receiving compensation. In addition, a foundation's directors and officers liability insurance may provide added protection, especially when defending against legal actions or when facing certain monetary damages. However, these protections may not always apply in a particular situation.

At the federal level, the IRS may impose financial penalties on board members for violating specific private foundation rules. Some of these penalties may be abated if board members have a reasonable basis for making their decisions but often this will not be the case. Here are the basics:

- *Self-dealing rules* prohibit certain financial transactions between a private foundation and its disqualified persons.<sup>1</sup> The self-dealing rules have certain exceptions, such as providing compensation for personal services (e.g., foundation management, investment management, legal services, etc.). Penalties may be imposed on the individual who participated in the self-dealing transaction and the foundation managers who approved the transaction.
- *Jeopardy investment rule* prohibits a foundation from making investments that jeopardize the carrying out of the foundation's exempt purposes. Penalties may be imposed on the foundation and the foundation managers for making investments that violate the prohibition against jeopardy investments.
- *The taxable expenditures rules* prohibit a foundation from making payments for non-charitable purposes. These rules generally apply to a foundation's grantmaking and provide rules and

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restrictions that must be followed if a foundation wants to give grants to individuals, foreign charities, or non-charitable organizations for a specific charitable project or charitable projects that involve lobbying and advocacy activity. Penalties may be assessed against board members and the foundation for failing to comply with these rules. (See the chart on page 7 for details).

There are two additional private foundation rules that apply only to the foundation itself:

- The *payout rule* requires a foundation to make minimum annual distributions equal to 5% of the foundation's assets.
- The *excess business holdings rule* prohibits a foundation, together with its disqualified persons, from owning more than a 20% interest in a business enterprise. Certain exceptions apply that allow a foundation to increase its business holdings in a business enterprise to 35%. In addition, a *de minimis* rule permits a foundation to own up to 2% of the voting stock and 2% of the value of a business, regardless of the ownership interest of a disqualified person.

At the state level, individual board members may also be held liable for violating state laws that apply to foundations in their governance and management of investments (e.g., the law of the state where the foundation is incorporated).

State attorneys general and the courts have significantly broader discretion in the types of penalties that they may apply to foundations and

<sup>1</sup> Disqualified persons, a term defined by the tax code, generally include substantial contributors to the foundation and its managers (e.g., directors and officers), as well as certain family members of these individuals, and businesses controlled by these individuals.

**PENALTIES IMPOSED UNDER THE PRIVATE FOUNDATION RULES<sup>1</sup>**

<b>Private Foundation Rule</b>	<b>Foundation Managers</b>	<b>Foundation</b>
<b>Self-Dealing (Sec. 4941)</b>	<p><u><b>First-Tier Tax:</b></u> Self-dealer – Must repay amount involved in self-dealing transaction and pay 10% tax per year on self-dealing amount.</p> <p>Foundation manager – 5% tax per year (up to \$20,000 per act) if knowingly participated in approving the transaction and the participation was willful and not due to reasonable cause.</p> <p><u><b>Second-Tier Tax:</b></u> Self-dealer – 200% tax per year on the amount involved if not corrected within applicable period.</p> <p>Foundation manager – 50% tax per year on the amount involved (up to \$20,000 per act) if not corrected within applicable period.</p>	N/A
<b>Payout (Sec. 4942)</b>	N/A	<p><u><b>First-Tier Tax:</b></u> 30% tax on undistributed amount.</p> <p><u><b>Second-Tier Tax:</b></u> 100% tax on undistributed amount.</p>
<b>Excess Business Holdings (Sec. 4943)</b>	N/A	<p><u><b>First-Tier Tax:</b></u> 10% tax on excess business holdings.</p> <p><u><b>Second-Tier Tax:</b></u> 200% tax on excess business holdings if not disposed of within applicable period.</p>
<b>Jeopardy Investments (Sec. 4944)</b>	<p><u><b>First-Tier Tax:</b></u> 10% tax on investment amount per year.</p> <p><u><b>Second-Tier Tax:</b></u> 5% tax on investment amount per year if not corrected within applicable period.</p>	<p><u><b>First-Tier Tax:</b></u> 10% tax on investment amount per year.</p> <p><u><b>Second-Tier Tax:</b></u> 25% tax on investment amount per year if not corrected within applicable period.</p>
<b>Taxable Expenditures (Sec. 4945)</b>	<p><u><b>First-Tier Tax:</b></u> 5% tax on each taxable expenditure (up to \$10,000 per each taxable expenditure).</p> <p><u><b>Second-Tier Tax:</b></u> 50% tax on each taxable expenditure if refused to agree to correction (up to \$20,000 per each taxable expenditure).</p>	<p><u><b>First-Tier Tax:</b></u> 20% tax on each taxable expenditure.</p> <p><u><b>Second-Tier Tax:</b></u> 100% tax on each taxable expenditure if not corrected within applicable period.</p>

<sup>1</sup>Note: All first-tier taxes, except in the case of self-dealing, are subject to abatement if a violation occurred due to reasonable cause and not willful neglect. All second-tier taxes are subject to abatement if appropriate correction is made within the applicable correction period.

nonprofits. At the federal level, the IRS must look to the tax code and to private foundation rules to determine what kind of penalties may be applied. Typically these are monetary fines or tax penalties. State remedies are much broader. Board members may not only face restitution and fines, but they may also be removed from the board and banned from serving in any fiduciary capacity with another charitable organization. Importantly, this is true of not just the board members who are responsible for the specific decisions that get a foundation in trouble, but for the entire board. Just because you are not the one actively making an inappropriate choice or decision does not mean that the state regulator may not remove you as well.

For additional information on laws applying to your state, please contact your state's attorney general office.

### **THE PRUDENT INVESTOR DEFINED: LAWS REGULATING INVESTMENT DECISIONS**

With the exception of the private foundation jeopardy investment rule, the basic rules that govern prudent investment management are found under state law. These laws are reviewed and revised on a continuing basis. Even if a particular law does not currently apply to foundations, it is important to be aware of the latest versions of these laws to understand the most current thinking regarding fiduciary obligations of a board in managing investments. For example, the most recently revised guidance is the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (2006). UPMIFA provides detailed guidance on the fiduciary duties of board members in managing investments. Brief descriptions of UPMIFA and other key laws related to foundation investments follow.

- *Uniform Management of Institutional Funds Act (UMIFA)*: In 1972, when the Uniform Law Commission released UMIFA, board members were expected to analyze risk on an asset-by-asset

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a prudent investment.**

basis, rather than across the portfolio as a whole. In addition, up until that time investments were regulated primarily by trust law, which did not permit delegation of investment authority, so involving investment advisors caused concern. UMIFA created new rules that made total-return investing and outside management possible for charities organized as nonprofit corporations.

- *The Uniform Prudent Investor Act*: This act was adopted in 1992 to further clarify that fiduciaries must seek to adopt a “modern portfolio theory” or “total returns” approach to investing. This approach requires foundation managers to analyze return in the context of the risk involved in making investments, and requires that investment performance be measured on the performance of the entire portfolio, rather than individual investments.
- *Uniform Prudent Management of Institutional Funds Act*. UPMIFA, adopted in 2006 (and since enacted, and thereby replacing UMIFA, in almost every state), built on the experience gained in the 35 years since UMIFA to provide clearer guidance in what factors foundation managers should take into consideration when making prudent investment decisions. UPMIFA requires fiduciaries to make decisions regarding investment management “in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstance.” UPMIFA also requires foundation managers to incur only “costs that are appropriate and reasonable” in connection with investment management. For more on UPMIFA, go to [www.upmifa.org](http://www.upmifa.org).



These three acts provide the basic elements of prudent investment management that foundation board members must keep in mind. These include:

- *Boards must exercise the care and skill of an ordinary prudent investor in managing a foundation's assets.* Foundations are not per se prohibited from making any particular type of investment. Investments are evaluated based on the performance of the foundation's entire portfolio.
  - *Boards should understand the jeopardy investment rules.* These rules generally comport with the state laws that govern investment management. Even though the regulations were written in 1972 and have not been updated since, the IRS generally follows modern portfolio theory and the basic state law rules when evaluating a foundation's investment performance and management. However, the jeopardy investment rules do specify a list of investment strategies that the IRS may subject to heightened scrutiny when inquiring about a foundation's investments. Investments on this list include puts, calls, options, investing in oil and gas leases, and other alternative investment strategies that in recent years have been taken for granted and which can be prudent investment management approaches if they are part of a comprehensive asset allocation strategy.
  - *Foundation investments should be consistent with the purposes and goals of the organization.* Foundations focused on a particular program or a particular purpose, or with grant commitments in a specified period of time should take these considerations into account when designing their investment strategy. Similarly, a foundation planning on spending down in 5 or 10 years is likely to have a very different approach to its investments than would a perpetual foundation.
  - *Foundations boards must diversify their investments.* There is a basic duty to diversify the foundation's investments, subject to certain special circumstances. One typical circumstance is when the donor provides restrictions on the assets, in which case the jeopardy investment rules provide an exception for these donated assets. This means that if the organization was founded by stock in a particular company and the donor said, "I would like you to retain those investments in this company," then the foundation would not be penalized under jeopardy investment rules for failing to diversify the foundation's investments. Nonetheless, this does not mean that boards should not take a close look at those investments on an ongoing basis and figure out whether they should be retained.
- *Board members responsible for overseeing the management of a foundation's investments must take cost into consideration.* Particularly with the recent shift toward alternative investments, boards must clearly understand the costs of their investment strategies, both in terms of the fees that investment managers take as well as the cost of doing due diligence. Boards should consider the options of passive versus active investment management. Finally, boards must understand the tax implications of selected investments; as an example, some alternative investments can result in unrelated business income tax (UBIT) to the foundation.
  - *The Board must retain active oversight of others hired to manage the foundation's investments.* The foundation's board may delegate the day-to-day investment management to outside professionals, but the board must act prudently when selecting managers, including defining the scope of the work and periodically reviewing and evaluating the manager.

Finally, keep in mind that legal compliance is evaluated at the time an investment is made. Foundation managers may be criticized for making or approving investment decisions that turned out poorly in hindsight. However, if the decisions at the time complied with standards of prudence required of fiduciaries, then the foundation managers will be protected from liability against allegations that they violated their fiduciary duties. On the other hand, board members cannot bet a foundation's assets on a horse at the racetrack and call it a prudent investment if their horse comes in. The rules do not work that way.

### ***Special Considerations for Private Foundations***

In addition to the basic laws governing investment decisions for nonprofits, there are a number of special considerations that private foundations must take into account when thinking about investment management. These include:

- ***Liquidity and payout:*** Payout rules require that foundations distribute an amount equal to 5% of their assets annually. During the latest economic crisis many foundations who had shifted significant percentages of their asset allocations to alternative investments that were subject to withdrawal restrictions struggled to free up enough cash to meet payout requirements. Some foundations continue to have difficulty meeting annual distribution requirements. Some of these foundations are asking whether they can borrow, and what the implications are if they borrow, to meet payout requirements.
- ***Investment costs:*** As stated previously, board members must take investment costs into consideration, particularly because these costs do not qualify toward foundations' payout requirements.
- ***Side-by-side investing:*** Side-by-side investing refers to situations where board members invest in the same types of funds (or, perhaps even the same fund) that a foundation is invested in. The IRS published several detailed letter rulings in 2003 addressing particular side-by-side investing issues. Any foundation that is thinking about side-by-side investing with one or more of its trustees should review these rulings with legal counsel and carefully consider the context and specifics of these arrangements to ensure that the foundation complies with the private foundation self-dealing rules.
- ***Mission related investing:*** Mission related investments (MRIs)—as well as program-related investments (PRIs), which are sometimes viewed as a subset of MRIs—are designed to help align a foundation's investment activities with the mission and values of the organization. A growing number of family foundation boards are choosing to describe this connection in the foundation's investment policy. While this can be a powerful investment strategy for many boards, it is important to understand the additional due diligence that this may require.

### **Elements of an Effective Investment Policy**

Family foundation boards should keep in mind that in the area of investments, process drives compliance with your fiduciary duties.

- ***Define purpose and objectives:*** a foundation's investment policy, management and strategies must inform the organization's charitable mission and objectives and, in turn, the charitable mission and objectives must inform the foundation's investment strategy.
- ***Define risk tolerance***
- ***List permitted and prohibited types of investments***
- ***Define asset allocation strategy and range:*** provide a clear explanation as to how the stated asset allocation will help to achieve the foundation's short- and long-term charitable objectives.
- ***Define your process for due diligence on investment managers:*** what questions will you ask investment managers when selecting and reviewing them?
- ***Special investments:*** whether these include MRIs, PRIs, or the latest exotic investment strategy, review and document (in an investment policy or the board minutes) the reasons for making these types of investments. Also consider imposing a cap on the amount of assets that will go toward these types of investments.
- ***Performance evaluation:*** describe the process for evaluating investment managers and consultants, and include a provision requiring the board and the investment committee, if there is one, to evaluate its own performance. The investment committee can be a subsection of the board or the entire board can serve as the investment committee.
- ***Process for reviewing policy:*** define who makes decisions about investments. Is it just one person or are decisions being made properly by the entire board or an investment committee? Are these committee decisions reviewed by the entire board?
- ***Record keeping:*** Keep records and documentation regarding how decisions are made.

## GOVERNANCE IN ACTION: PROMOTING GOOD PRACTICE

In the final section of this paper, we look at what boards must do to promote good practice in foundation governance, and introduce creative tools that foundations have used for this purpose.

The first step to good governance practice is to orient incoming board members to the foundation and its regulatory environment. Yet in a poll of attendees at the 2005 Family Foundations Conference, 37% of trustees said that they received no orientation or that the orientation was “insufficient.” Only 17% reported receiving “comprehensive” orientation. Clearly, foundation boards understand that orientation and ongoing board education are an important but still neglected practice in family foundations.

Hildy Gottlieb, President of the Community-Driven Institute, and author of several acclaimed books on effective nonprofits, suggests simple, common sense advice for those looking at creating an effective board orientation process: “Just ask the board what they wish they had known as new board members and also what information they feel that they lack now.” Spend half an hour at a board meeting answering this question, compile an orientation agenda or a board education agenda and then determine what experts you have from within and who you need to call in to address these questions. If you have staff, identify where staff input is needed so that their concerns and suggestions are not overlooked.

Once the orientation agenda and materials are identified, compile a manual for board members (current and new), both to get them started and for their reference throughout their service. Items to consider for a board manual include:

- organization history, bylaws and committee charters
- board member responsibilities or job description
- program focus and descriptions of ongoing programs

**Defining and articulating policies force family foundation boards to think at a very practical level.**

- background on finances such as recent financial statements or audits
- copies of the investment policy and spending policy
- recent minutes and the latest copy of the foundation’s Form 990–PF

For a sample board orientation book table of contents, contact the National Center for Family Philanthropy, or visit the Family Philanthropy Online Knowledge Center at [www.ncfp.org](http://www.ncfp.org). Other good sources for “best practices” on orienting, training, and building boards include BoardSource ([www.BoardSource.org](http://www.BoardSource.org)), the Independent Sector ([www.independentsector.org](http://www.independentsector.org)) and the Council on Foundations’ ([www.cof.org](http://www.cof.org)) Stewardship Principles for Family Foundations.

Board building and board education is a continuum. The concept of leadership succession sounds like one individual and a one-time event, but a much more descriptive and accurate concept for foundation boards is *leadership continuity*. It’s an ongoing process. For more information, consult these NCFP publications: *Generations of Giving*, *Voyage of Discovery*, and the *Trustee Orientation Notebook*.

### **Pursuit of Excellence**

Pursuit of Excellence (POE) is a self-assessment tool for family foundations interested in improving their governance practices. The POE tool is designed to identify their strengths as well as opportunities for improvement, and includes assessment questions regarding family-specific aspects of governing and managing a foundation. POE provides the information families need to measure and compare their individual model of philanthropy with the broader field, and provides resources to develop an action plan which addresses identified areas for improvement. For more information, contact the National Center for Family Philanthropy at 202.293.3424.

### ***The value of looking inward: board self evaluations***

During the Red Cross scandal which followed Hurricane Katrina, Senator Grassley of the Senate Finance Committee asked the Red Cross when their board had last conducted a self-evaluation. In other words, was the board even aware of what they were good at, what they were not good at, and how they could improve their governance of the organization?

Cases of bad foundation management that have been exposed in the media have been great motivators for many family foundation boards. High profile mistakes have alerted board members and foundation staff to different management and oversight areas that might require attention. Even though a board may not be doing anything wrong at present, absent certain policies they might not have a systemic means of ascertaining when things go wrong—and they won't be prepared for the future.

In light of the scandals, many family foundation boards have adopted board member position descriptions to clarify performance expectations. Position descriptions of this type are useful regard-

less of whether individual board members serve on a volunteer basis. Some boards also choose to undertake a self-evaluation process, perhaps once every two to three years. Such a process generally feels less threatening than people evaluating one another or having an outside evaluation. More importantly, it can provide a clear indication of where board members themselves feel weak and where educational opportunities exist around investments or other fiduciary duties.

### ***Implications of the new Federal Form 990: Evaluating current practices of your foundation***

One important motivator for foundation boards has been the recently revised Federal Form 990 for public charities. While the IRS has stated that these are not legal requirements under the federal tax code, it's safe to say that public charities (grantees) that cannot answer "yes" to these questions may be waving little red flags that say to the IRS: "if you're going to do audits, audit me first!" These questions also give a clear sense of the IRS's views of what good practice means, and could easily apply to family foundations. Part VI of the new Form 990 asks a series of questions regarding an organization's governance practices, including whether minutes of board and committee meetings and a conflict of interest policy exist. Other important activities related to tax filings include:

- ***990-PF review.*** A foundation's 990-PF Form documents the foundation's grant history and expenses in a public document and, in many cases the primary window into the foundation's work for grantees, the general public and the press. In the age of Guidestar, Foundation Finder and the Internet, any foundation's 990-PF is at anyone's fingertips. Board members should review their 990PF so that they know how the work of the foundation is being presented to a worldwide audience.
- ***Compensation review and performance appraisal.*** Many family foundation staff are either never

evaluated or have only cursory performance evaluations. To address this, one option is to include the executive staff's performance appraisal as part of the compensation policy. The public has many negative assumptions about family foundations and family staff. While in reality family members who serve as staff earn less than most non-family member foundation executives, the public has an insatiable appetite for stories about family members who abuse foundation assets for personal benefit. To guard against this, be sure to substantiate your compensation policy by taking the following basic steps:

1. Review comparable compensation data (available from the Council on Foundations or Guidestar),
2. Conduct an annual board review and approval of the compensation policy,
3. Document the process and keep a record of salary decisions by the board.

And if you truly want to promote good practice, take it one step further and create an annual staff performance appraisal that is tied to the compensation policy.

- *Audits*: While not typically required for family foundations because they do not solicit funds,<sup>2</sup> audits can ensure that financial practices and policies are conducted according to the Generally Accepted Accounting Principles. Family foundation boards should determine how thorough a financial oversight they require depending on the foundation's size and complexity. From the least to the most stringent, options include financial compilations, financial reviews and audits. For many boards, it will be useful to do at least one of those every couple of years.

Clear and comprehensive governance policies serve a vital role in filling in the gaps left by the law. Despite all the federal and state laws and rules applying to investment management, on a practical level there remain many decisions that are not addressed by existing laws. Defining and articulating policies force family foundation boards to think at a very practical level. How do we fulfill our fiduciary duty? How do we ensure that we have clarity around the roles and responsibilities of our fellow board members?

Policies can also help foundation boards avoid disagreement and heartache. Especially with family foundations, board members may think they share assumptions when in reality they do not. For example, some board members may think it is perfectly okay (and perhaps even desirable) for board members to serve on grantee boards. Others on the board may see this as a conflict. Another example: a family member is hired to handle investments and the board does not set investment benchmarks or evaluation parameters in advance. A period of poor investment returns can easily lead to disagreement on whether to retain the family member. Therefore, doing this work proactively is very helpful. If the board does not discuss these issues as a matter of foundation policy and governance, the board may never know about potential sources of disagreement until the issues arise.

Finally, at an even more practical level, if a board is ever under examination by a state regulator or the IRS, one of the first things they will ask for are your written board policies. Having a record of decision making—how decisions were made and what were the determining factors—will go a long way towards demonstrating the duty of care and loyalty that is required of your board.

**TIP: Proactive policymaking prevents problems.**

<sup>2</sup> It is always important to check any state law requirements that may apply to private foundations. For example, the California Nonprofit Integrity Act of 2004, which does apply to private foundations, may require certain private foundations with gross revenues of \$2 million or more to obtain an independent financial audit and to establish an audit committee.

**Q and A**

*Question: should a board focus on the 990PF? Is it really worth the trouble? My board is scattered all over the country. How do foundations with geographically dispersed boards ensure that their boards review and sign off on the 990-PF, when the board is so infrequently together?*

*Answer:* Yes, it's very important, but don't expect them to come together for an extra meeting just for this purpose. Consider sharing a draft and providing the board with a defined timeframe to review it—perhaps 10 days. If people have questions or concerns, offer them the option of a teleconference. If possible, ensure that everyone has reviewed the document before submitting it to the IRS – and keep in mind that any information included in a foundation's 990PF is available to anyone with access to the Internet.

*Question: how important is it to bring in 'outside voices'?* My sister and I run a small family foundation. We have a family accountant who oversees everything we do. Our investment decisions are all made by an investment firm, all four of us make the decisions together, and that is all documented. We've been advised that we should bring in an outsider who represents the members of our community. Am I doing something bad by maintaining my foundation with just myself and my sister as trustees with professional help from my family accountant and professional help from an investment advisor?

*Answer:* It is important that you document the process you're going through regarding the board's decisions about governance. Put these thoughts down as part of your board minutes, and describe the considerations you are taking into account and the reasoning for your conclusions. This basic description of your thinking will help provide documented support for whatever conclusion you come up with. It's a good example of how recording and documenting one's decision-making is an important part of the governance process.

*Question: How do you exercise your fiduciary responsibility to question your professional consultants when they give advice that appears to be focused more on the latest hot trend than on rational investment strategy?* We are a fairly large foundation and we have both investment managers and an investment advisor who recommends managers to us for our approval and then evaluates the performance for us. One question that's been troubling me, certainly since the Madoff scandal, but more related to the financial meltdown that we all struggled with, is the tendency of so-called experts to race toward the newest hot trend in investing, such as the mortgage products that caused the last crisis. If our investment managers had invested in these things, or if our investment advisors had recommended these things and we didn't have a former bank executive on the board, who knows what might have happened? How do we ensure that boards such as ours exercise fiduciary responsibility and really question professional consultants?

*Answer:* Your point about trends is excellent. When you review investments quarterly or broadly on an annual basis with your investment consultants, bring up the conversation about global trends. What trends are the consultants seeing? What are the new latest and greatest financial products and strategies they are using? Ask them for a list of these trends and discuss whether you want to be invested in them or whether you may want to put certain strategies on a prohibited list. The point is that you don't have to be the front runner. There are examples of prominent family foundations that declined the opportunity to invest with Madoff. Jeff Solomon, the executive director of the Andrea and Charles Bronfman Philanthropies, says that the reason they didn't do so is that he didn't get a reasonable answers to questions, such as how are you able to make such consistent returns year after year?

## CONCLUSION

Where are the regulations on fiduciary responsibility and foundation investments headed? No one is yet sure, but there are renewed calls to increase the regulation of foundations, especially with respect to investments. Some have suggested that state attorneys general and the IRS investigate foundations that experience significant declines in assets as the result of their investment management. Some state

attorneys general are making general inquiries of family foundations already.

One of the most important lessons learned is that governance must be *embedded* in an organization's policies and within an organization's culture. When reviewing decisions about investments that did not turn out well in hindsight, the board can protect itself by having a written record showing that it conducted proper due diligence, was paying attention and actively managing the foundation's affairs.

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**Andras Kosaras** is an associate with Arnold & Porter LLP's tax practice group. Mr. Kosaras primarily represents tax-exempt organizations. His experience includes advising private foundations, public charities, donor advised funds and community foundations on a variety of legal issues, including qualification for exempt status, charitable contributions, philanthropic giving, international grantmaking and operations, intermediate sanctions, private foundation rules and corporate governance issues. Previously, he served as an attorney and director of the Council on Foundations' Building Strong and Ethical Foundations initiative, a program that aimed to improve the governance practices of private foundations.

**Karen Green** is President of The Healthcare Initiative Foundation in Bethesda, Maryland, a nonprofit, grant making trust governed by an independent, volunteer board of trustees. Prior to her work with the Healthcare Initiative Foundation, Karen served for 10 years as Managing Director at the Council on Foundations, first of Family Foundation Services and subsequently of Governing Board Programs.

**Jason C. Born, Editor**

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1101 CONNECTICUT AVE. NW, SUITE 220, WASHINGTON, DC 20036 TEL: 202.293.3424 WEB: WWW.NCFP.ORG



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