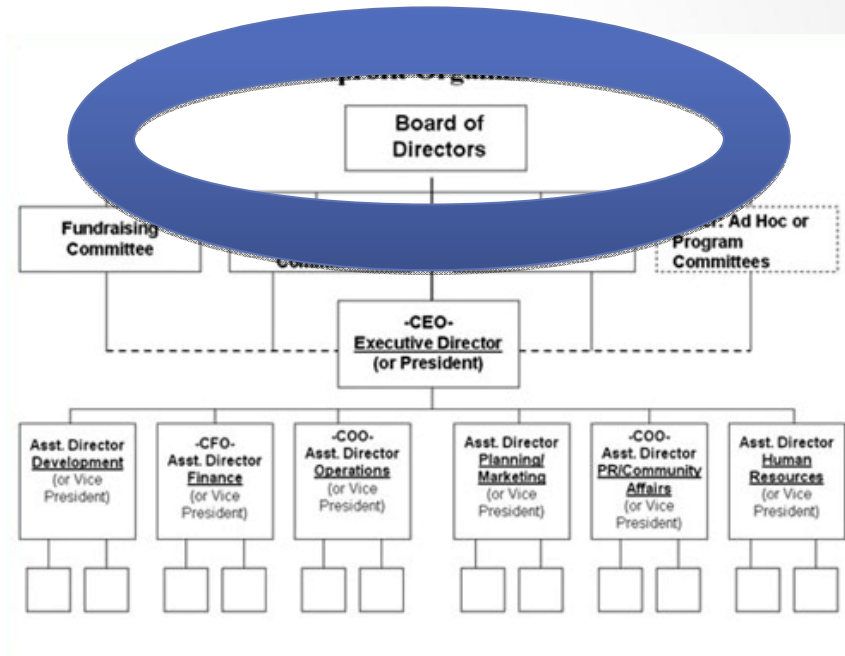
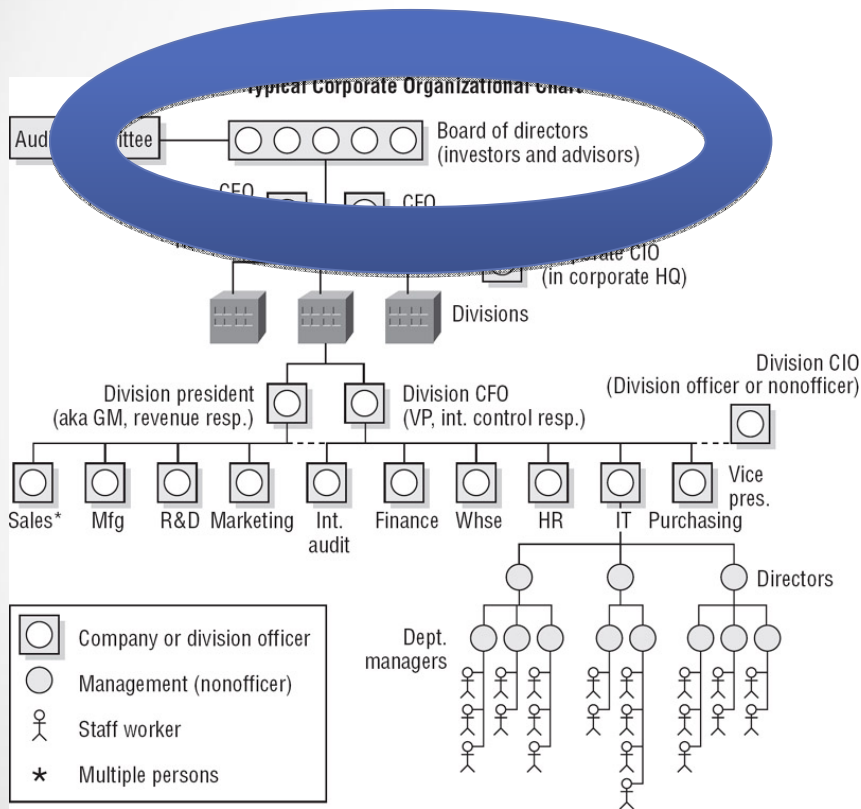


Director Primacy in Nonprofit Organizations

Who's in charge?

Stephen M. Bainbridge
William D Warren Distinguished Professor of Law
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Director Primacy a.k.a. Board-centric Governance



Director Primacy

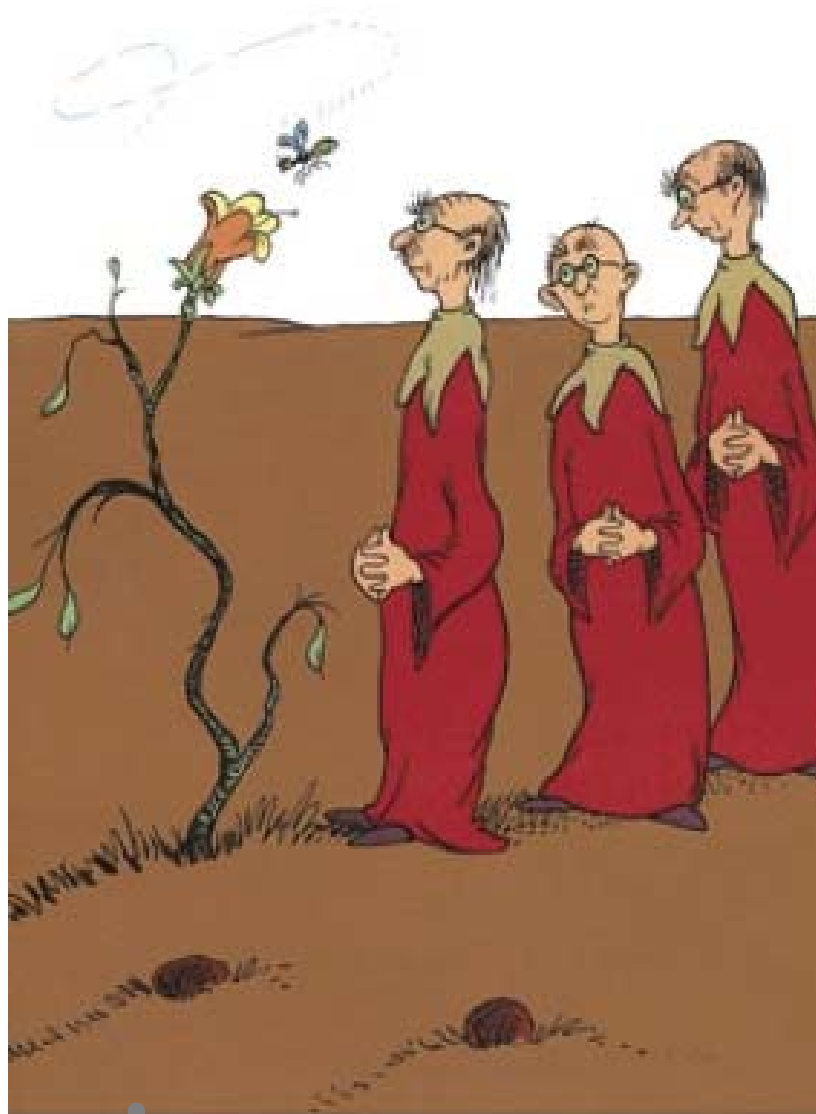
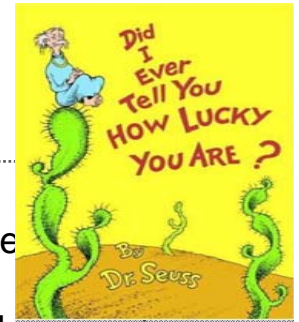
a.k.a. Board-centric Governance

Corp. Code § 300(a)

- “the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board.
- “The board may delegate the management of the day-to-day operation of the business of the corporation to a management company or other person provided that the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.”

Nonprofit Corp. Code § 5210(a)

- “the activities and affairs of a corporation shall be conducted and all corporate powers shall be exercised by or under the direction of the board.
- “The board may delegate the management of the activities of the corporation to any person or persons, management company, or committee however composed, provided that the activities and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.”



Out west, near Hawtch-Hawtch,
There's a Hawtch-Hawtcher Bee-Watcher
His job is to watch...
is to keep both his eyes on the lazy town bee.
A bee that is watched will work harder, you see.
Well...he watched and he watched.
But, in spite of his watch,
that bee didn't work any harder. Not mawtch.
Our old bee-watching man
just isn't bee-watching as hard as he can.
He ought to be watched by another Hawtch-Hawtcher.
The thing that we need
is a Bee-Watcher-Watcher."
WELL...
The Bee-Watcher Watcher watched the Bee-Watcher.
He didn't watch well. So another Hawtch-Hawtcher
had to come in as a Watch-Watcher-Watcher.
And today all the Hawtchers who live in Hawtch-Hawtch
are watching on Watch-Watcher-Watching-Watch,
Watch-Watching the Watcher who's watching that
bee.



A further complication

- Team production
 - Task non-separability
 - Alchian and Demsetz 1972:
 - The marginal productivity of each worker is very difficult to measure and their joint output cannot be easily separated into individual components.
 - Hence, obtaining information about a team member's productivity and appropriately rewarding each team member are very difficult and costly.
 - Absent such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness.



Quis custodiet

ipsos custodes?



Armen Alchian and Harold Demsetz 1972:

- Pay team members a fixed wage
- Appoint one team member to be the monitor
- Give the monitor right to revise contracts and fire/hire workers
- Grant the monitor the residual claim on the income of the team
- Profit incentive motivates monitor

Theory Into Practice

For Profit Corporations

- Residual claim assigned to shareholders
- But shareholders cannot monitor:
 - Widely dispersed
 - Differing interests
 - Collection action problems

Nonprofit Corporations

- No profits to assign
- No residual claimants

“all corporate powers shall be exercised by or under the direction of THE BOARD”

Why a Board?

Quis custodiet ipsos custodes?

Magisterium

The Organization

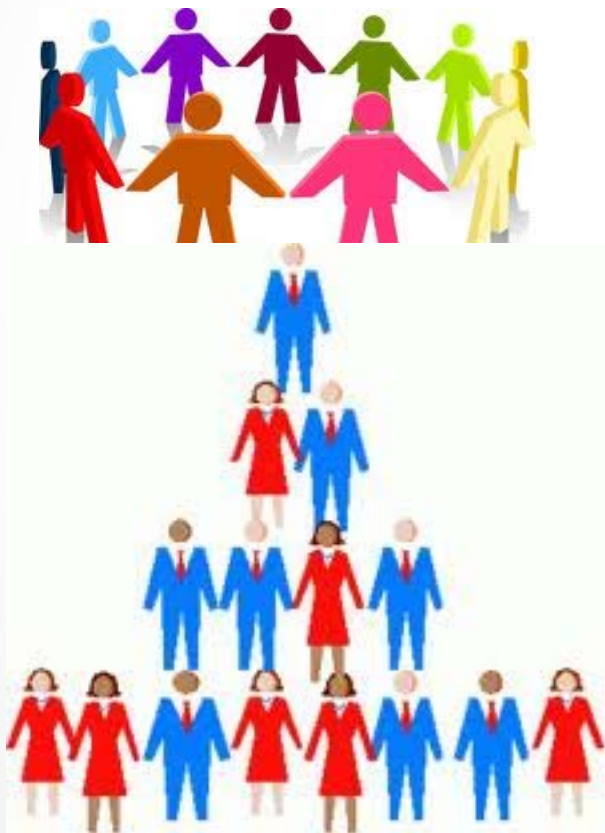
The Board as a Monitoring Mechanism



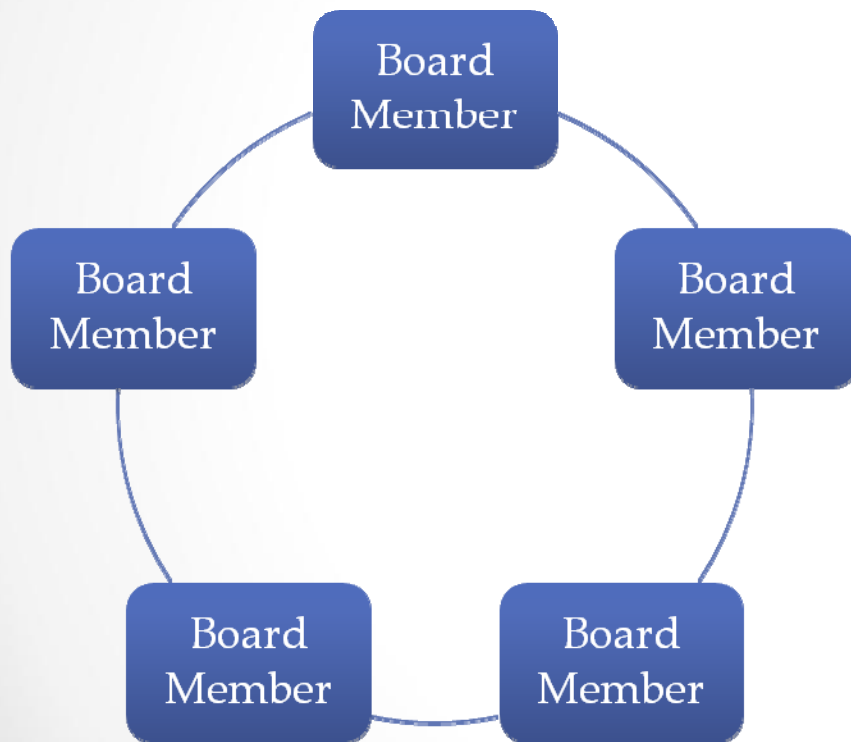
- A hierarchy of individuals whose governance structures contemplate only vertical monitoring cannot resolve the problem of who watches the watchers.

The Board as a Monitoring Mechanism

- Add a horizontal dimension by putting a group at the top of hierarchy
 - An individual autocrat would have substantial freedom to shirk or self-deal
 - But the internal dynamics of group governance constrain self-dealing and shirking by individual team members and, thus, by the group as a whole



The Board as a Monitoring Mechanism



- Within a team of status equals, mutual monitoring and peer pressure provide a coercive backstop for a set of interpersonal relationships founded on trust and other non-contractual social norms
 - Of particular relevance here are effort and cooperation norms

Statement of the Thesis

- The board of directors is an adaptive response to the problem illustrated by Dr. Seuss' honey business
 - The board solves the problem by providing a self-monitoring hierarch whose internal governance structures provide incentives for optimal monitoring of its subordinates
 - Mutual monitoring and social norms, enforced through peer pressure and reputational sanctions, provide important constraints on behavior.
 - In addition, a multi-member board is inherently harder for misbehaving subordinates to suborn than would be a single autocrat. Instead of having to bribe or otherwise co-opt a single individual, the wrongdoers now must effect a conspiracy amongst a number of monitors. Consequently, the board potentially can provide a significant institutional constraint on agency costs.

Theory into Practice

...

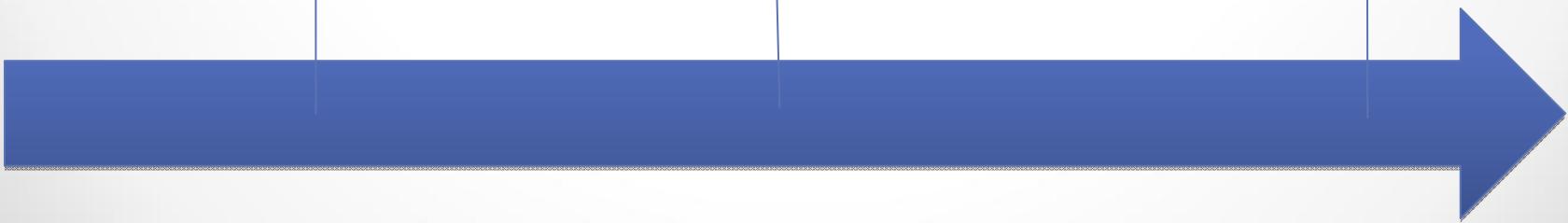
Demand for Improved Vertical Monitoring by Boards

Boards of yesteryear

“Directors do not
direct”
-- William O.
Douglas, 1934

“an imperial CEO ... with a supine
board”
-- In re Walt Disney (2005)

Directors are “cuckolds,” who are
“the last to know when
management has done something
illicit” –
Ralph Nader (1974)



The Critique Persists

- “Too many nonprofit governing boards are not taking their positions seriously and shirking their oversight responsibilities....”
- “Responsibility for the numerous recent mishaps of nonprofit groups lies with the governing board.”
- “The road to regaining the public trust must begin with charity boards because they are in the best position to improve the integrity of their organization.”
- --CharityWatch.org

New expectations

- The Impetus

- Caremark & Stone v. Ritter
- Sarbanes-Oxley
- California Nonprofit Integrity Act
- State attorneys general investigations of mismanagement by nonprofit boards
- IRS Form 990
- Dodd-Frank

- The Result

- A decade-long trend of corporate law and governance becoming key considerations for nonprofit organizations:
- Increased oversight from state and federal regulators
- Greater focus on corporate governance practices
- Closer scrutiny of the exercise of business judgment by boards

Horizontal Monitoring Failures

- Rubberstamping staff recommendations, and abstaining from dicey decisions.
 - Today, board service comes with real responsibilities and real consequences for those that fail to live up to them.
- Failing to provide effective oversight.
 - Boards are entitled to delegate tasks to committees, officers, staff, and professionals, but only if they perform sufficient oversight.
- Deferring to the executive committee, board chair or the organization's founder.
 - No one committee, director, or individual can control the organization. Instead, the board must

Horizontal Monitoring Failures: Insider transactions

- Transactions between the organization and a staff member or director
- Transactions between the organization and a person or entity in whom a director has an interest

How to Handle

- Disclosure of conflict and all relevant facts
- Approval by disinterested directors
- Transaction is fair to organization
 - What is “Fair”?
- If litigated, burden of proof is on director to prove standard met
- Be sure to understand and comply with organization conflict policies

New Expectations re Compensation

- Nonprofit financial scandals not new
 - Nonprofits should already have dealt with compensation issues in wake of IRS Form 990 and other developments
- Dodd-Frank compensation rules don't apply to nonprofits, but should prompt new look at:
 - Use of compensation committees and consultants
 - Careful evaluation of independence and skills of compensation consultants and advisers
 - Identification, specification, and enforcement of performance metrics

Evaluating Compensation Committees

- In determining “independence” of committee members, D-F factors to be considered include:
 1. A committee member’s sources of compensation, including any consulting, advisory or other compensatory fee paid by the company to the member,
 2. Whether the member is affiliated in some other way with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.
- Critical to evaluate not just financial ties.
- “Homo sapiens is not merely *homo economicus*. ... Think of motives like love, friendship, and collegiality....”
 - Delaware Chancellor Leo Strine

Evaluating Compensation Consultants

- D-F factors to consider in assessing a consultant's independence include:
 1. Whether the consultant provides other services to the company
 2. The amount of fees received from the company by the consultant
 3. The consultant's internal policies and procedures to prevent conflicts of interest
 4. Any business or personal relationship of the consultant with a member of the compensation committee or management.

Theory into Practice



Improving Horizontal Monitoring

Create Expectation Norms

- A board's basic fiduciary duty:
 - Ensure that the nonprofit is run effectively and that charitable assets go towards the interests of the beneficiaries, not the pockets of insiders
- Who watches the management?
 - It is up to boards to monitor management
 - But it is also up to management to monitor themselves
- Boards must communicate **social norms** committing all members to honoring fiduciary duties

Social norms are the informal rules that groups adopt to regulate group members' behavior

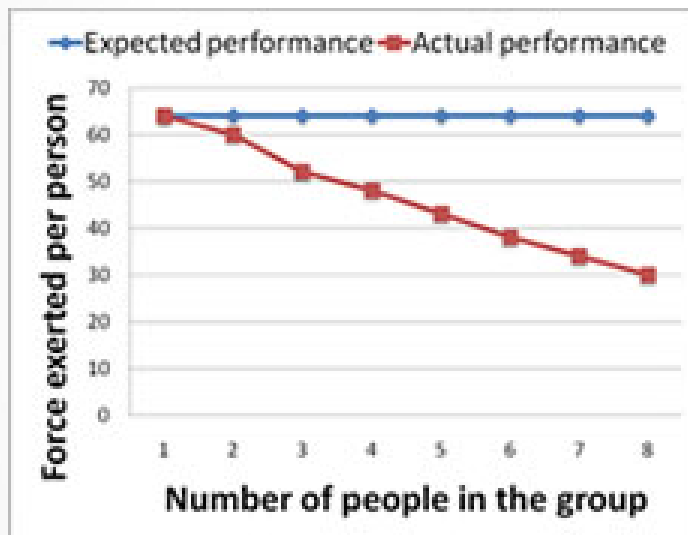
The Hat Analogy

- People take their hat off in church even when no one else is present
 - Inculcated social norm
- When nonprofit boards govern effectively, it is because fiduciaries are morally committed to abiding by fiduciary duties, regardless of whether the law enforces them
 - Inculcated social norm

Constituency Representation and Stakeholder Pressure

- Directors owe fiduciary duties to their corporation, and not to any particular corporate constituency
- The duty of loyalty demands that a nonprofit director act in the best interests of the nonprofit, and not for her own personal interests
 - Includes duty of obedience to mission of nonprofit
- Directors' and officers' "fiduciary obligation to a corporation means that they must manage the corporation solely in its best interest, not as a vehicle for promoting their personal beliefs or causes." Fletcher Cyc. Corp. § 844.10

Create Effort Norms



Social loafing:

Groups can be fantastically unproductive because they provide such wonderful camouflage. Under cover of group work people will slack off, happy in the knowledge others are probably doing the same. And even if they're not: who'll know?

Create Effort Norms

- Because people care about how they are perceived by those close to them, decision making by groups provides a “cloud of witnesses” whose good opinion we value
- **Effort norms** will thus tend to discourage board members from simply going through the motions, but instead to devote greater cognitive effort to their tasks
 - Regulators and stakeholders expect directors to be informed (e.g., Van Gorkom)
 - Inculcate a norm that says: Directors are expected to probe senior executives and gather more information can now say they

Create Anti-Groupthink Norms

- Tolerate dissent
 - Encourage devils advocacy by directors
- Encourage appointment of diverse directors, including intellectual and values diversity
 - Outsider mentality
- Willingness to seek outside/independent advice and counsel
- Encourage board independence

Building Norms

- Spend time as a group
 - Board-only meetings
 - Board team-building exercises
 - All group members are equal.
 - Every group member's opinion will be thoughtfully considered
 - Group members will speak respectfully to each other
 - Group members will listen without interrupting
 - Board trust-building exercises
 - Each group member will keep all commitments.
 - Each group member agrees to constantly assess whether group members are honoring their commitment to group norms
- Regular review of nonprofit governance best practices and critical adaptation to organization

Conclusion

