Lessons for Nonprofits from the Freeh Report

July 2012

James H. Hahn, Esq.

The law firm of Freeh Sporkin & Sullivan LLP, in its capacity as Special Investigative Counsel for the Board of Trustees of The Pennsylvania State University, recently issued its report (the "Freeh Report") on Penn State's handling of allegations of child sexual abuse by former football coach, Gerald Sandusky. The report documents how even the Board of Trustees of a well-funded, public university can fail in its corporate governance responsibilities. Although prepared in response to a horrific situation, the Freeh Report contains important lessons for anyone who undertakes the responsibility of serving as a director of a nonprofit corporation – regardless of size or resources. Click here for a link to the Freeh Report.

What can nonprofit directors learn from the Freeh Report? The most important part of the Freeh Report for nonprofit directors generally is its conclusion about how the Sandusky scandal came about. The Freeh Report concluded that **the Penn State Board was over-confident in its President's abilities and failed to conduct oversight and responsible inquiry of him and other senior University officials.** Over-reliance on the senior executive is a common occurrence on nonprofit boards, and it arises for a number of very practical reasons that board members, exercising the fiduciary duty required of them in their board capacity, must resist.

How does a board become over-reliant on its chief executive? Part of the cause is endemic in governance itself, part arises from human nature and part may be evolutionary. Governance questions are sometimes tedious; they focus on process and procedure. It is hard for directors to respond to governance issues with the same enthusiasm they bring to personal stories and successes that often accompany a focus on the organization's mission. Governance issues can be boring.

Board members often fail to ask proper governance questions because they do not want to rock the boat – "surely the organization has operated appropriately in the past and it must be doing so now?" A director may be unsure about proper board governance standards and may keep quiet to avoid appearing unknowledgeable. A director may not want to be the one who raises a potentially controversial issue. It is often an honor to be asked to serve on a board, and it is

human nature to want to fit in. Often, the organization's chief executive, whether given the title of President or Executive Director, is a long-serving expert who is the public face of the organization. This can also be true of long-serving committee chairs. A director may feel uncomfortable raising a governance issue which might offend the chief executive or other respected board members. This is particularly true for newly appointed directors.

Governance issues also arise because the organization evolves, and what might have made sense for a small organization with a limited budget may no longer be appropriate. Unless a system is in place to review governance issues on a regular basis, the organization's governance procedures may no longer fit its size, structure or mission.

Whatever the reason, it is often hard to be the person who asks the prickly questions about governance. Consequently, it is important for nonprofit boards to recognize that governance may be inadvertently ignored and put systems in place to address that possibility. At a minimum, a committee of the board must be given responsibility for board governance. This is not a bylaws committee asked to parse words, but rather a committee charged with evaluating how the board governs both itself and the organization and with thinking seriously about what systems and procedures must be in place in order to permit the board to carry out its fiduciary duties effectively. Although the board is ultimately responsible for governance, making it a committee responsibility that is reported on at each board meeting makes governance an acceptable topic and provides a useful forum for individual directors to raise concerns that can be addressed by the committee and brought to the full board for action.

Resources must be devoted to governance. The governance committee must be charged with periodically evaluating the organization's governance process. To do so effectively, it requires resources to learn best practices and evaluate how those might be implemented by the organization. (For any organization, a review of the questions on governance and management found in Part VI of IRS Form 990 – Return of Organization Exempt From Tax can provide a starting point for policies to be considered, adopted and implemented.) Resources are also required for follow-through. For example, it makes no sense for the board to adopt a conflict of interest policy if no one is charged with ensuring that conflict questionnaires are completed and information about potential conflicts is compiled and shared with the board. Finally, time and resources must be devoted to training existing and new directors not only on the organization's history and mission but also on how the board effectively governs the organization.

The board should have in place an organizational whistle-blower policy, so that employees know how they can, in good faith, report potential misconduct within the organization, including to the board if necessary based on whose conduct is implicated, without fear of retaliation.

Systems must be put in place to require proper reporting to the board. Part of the board's regular agenda should include a chief executive's report addressing changes in the regulatory environment in which the organization operates, implementation of compliance procedures, significant issues and risks affecting the organization, potential issues that could impact the goodwill and public reputation of the organization, and material actions taken by the chief executive or others that are outside of the ordinary course of the organization's business, including reports and actions taken to address whistle-blower complaints.

Finally, part of the agenda for each board meeting should include time for an executive session. If an executive session occurs at each board meeting, if only for board members to agree in private that there is nothing to address, then the occurrence of an executive session is less threatening to a chief executive or other employees who regularly attend board meetings. Otherwise, a board member who wants to discuss an issue related to chief executive or other staff performance is put in the position of requesting an executive session while the person is in the room. Although board members should always feel comfortable making such a request, making executive session a part of each board meeting eliminates whatever discomfort might arise on the part of the person who believes an executive session is required.

Partridge Snow & Hahn LLP provides advice to nonprofits and their directors on issues of corporate governance. Several years ago, the firm prepared a brochure for nonprofit directors that is distributed upon request. The brochure has been recently updated, and we have separate brochures for nonprofits based in Rhode Island and Massachusetts to address the unique rules in each state. If you believe these might be of use to you or a nonprofit board on which you serve, or if you have questions about corporate governance, please contact one of the members of our nonprofit group – Ted Howell, Kim McCarthy, Jim Hahn or Chris Cassara.