Nonprofit Risk Management Center

The Culture of Reflection: Lessons Learned from Recent Headlines

By

Resource Type: Risk eNews

Topic: Governance

While it's human nature to want to look away or think "this couldn't happen to me" when you witness or read about another nonprofit's misfortune, dedicated leaders should commit to adopting a "culture of reflection" that embraces the lessons in unfortunate events. At the Center we've been asked numerous times over the past weeks whether any one of the many organizations we work with around the country have been affected by the Madoff scandal. The answer is that *every* nonprofit has been affected to some degree.

In this week's *eNews* we explore two questions that so many nonprofits and their boards are asking: "If this happened to us, could I be held responsible?" and "How can we protect our nonprofit from a similar fate?"

Can board members be liable for investment losses?

Generally the standard for a public charity (as opposed to a private foundation) is the 'reasonable person' standard—what would a reasonable person do under the circumstances? Consequently, board members who make *good faith decisions* about investments are generally **not liable** when those investments go south. In contrast, investment experts, whether in-house staff or experts hired for that purpose, may be held to a standard of care consistent with their status as experts in financial management.

- The common law requires charities to invest "prudently" and while such prudence encourages diversification of assets, there is no specific guidance about what instruments charitable organizations should or should not invest in.
- The Uniform Prudent Management of Institutional Funds Act (UPMIFA), has only been adopted by 25 states and the District of Columbia.[1] UPMIFA requires charitable organizations to manage investments "in good faith andwith the care an ordinarily prudent person in a like position would exercise under similar circumstances." The Act addresses the need to control the cost of investing, authorizing "only costs that are appropriate and reasonable." Additionally, UPMIFA requires a charitable organization to:
    - diversify assets unless "special circumstances" dictate otherwise, and to
    - review assets within a reasonable time after they come into the possession of the organization in order to conform them to the investment strategy adopted by the organization
- There is a dearth of reported cases finding board members liable for financial mismanagement. Where those reported cases exist they demonstrate that courts have been reluctant to find volunteer board members responsible for investment losses. In one case, *Stern v. Lucy Webb Hayes National Training School*, 381 F. Supp. 1003 (D. D.C. 1974) the court found mismanagement and self-dealing, but imposed a minimal penalty. That case is now ancient history. Today, it's not certain that a court would be so forgiving.

What about charitable immunity? Aren't uncompensated board members immune from lawsuits anyway?

While it is true that in many states uncompensated board members serving nonprofit organizations are protected by liability shields (state volunteer protection laws and the federal Volunteer Protection Act) for negligent conduct, board members must discharge the legal duty of care which encompasses protecting the assets of the nonprofit. Violations of that duty can result in either a lawsuit against the board and the organization or an investigation and action by the state attorney general that can result in the removal and replacement of board members. Nevertheless, board members are generally *not liable* when investments perform poorly in the absence of gross negligence, willful misconduct or self-dealing.

State Attorney Generals Take a Closer Look

Attorney Generals in New York and Connecticut have started to investigate the boards of foundations and other nonprofits that invested in the Madoff Ponzi scheme. The Attorney General for the State of Connecticut recently told *Forbes*, "If they failed recklessly to do the necessary due diligence, we would certainly investigate and take action." Whether or not a board has failed in its fiduciary responsibilities, our society is now super-sensitized to the devastating losses and that one investment manager can cause. Consequently, the days of board members ignoring poor investment performance or failing to conduct due diligence on who is investing the nonprofit's funds should be behind us. Whether and how board members will be "punished" remains to be seen, since the law currently does not allow for personal liability in the face of investment losses on otherwise imprudent investments.

How Can We Investment Scandal-Proof Our Nonprofit?

- **Take a fresh look at your investment policies**: According to *The Chronicle of Philanthropy* over a quarter of the nonprofits participating in a September 2008 Grant Thorton survey **revised their investment policies within the past year.** The scrutiny of many investment policies prior to September was most likely due to concerns with higher-risk "alternative investments" that started to falter earlier in the year. Wide-ranging losses in the financial markets in recent months are a reminder that every nonprofit can benefit from revisiting its investment philosophy and strategies. Typically investment advisors recommend reviewing investment goals, strategies and guidelines annually.
  - Investment policies might focus less on chasing high returns, than on positioning the nonprofit for a market rebound and meanwhile maintaining principal, which means keeping higher risk/reward investments to the lower range, such as 10%-15% of the charity's investment portfolio. A recent report on several high profile university endowments indicated that the funds reserved only a small percentage (under 10%) of the total portfolio for liquid, relatively safe investments. Those endowments lost close to 30% of their net worth due to this high-return/high-risk strategy. *The Chronicle of Philanthropy* reported this week that some managers are reducing risk by moving as much as 30 percent of their funds into cash-like investments that can be used to cover commitments in the next few years.
  - Many organizations suffering the heaviest losses as a result of the Madoff Ponzi scheme were those that had forgotten the golden rule of diversification. Lack of diversification now seems shocking. However, keep in mind that decision-makers may have been lulled into believing that their portfolio was "diversified" because of reports they received showing various investments that in the end turned out to be fictitious. Consequently, the lesson learned is that diversification goes beyond individual holdings and requires boards to ask, not only whether the overall total portfolio is diverse, but also WHO is investing the funds. If there is only one investment manager, are your nonprofit's investments really diversified?
  - If there is an investment committee, who is serving on the committee? When outsiders question a nonprofit's investment decisions, one of the questions posed will certainly be, "Who was monitoring the charity's investment policies?" and "What are their qualifications for overseeing investment decisions?"

- **Remember to ask: where's the money?** Whether the nonprofit's investments are in the local bank or in mutual funds with Vanguard, an independent financial institution has custody of the funds. That firm is required to provide the nonprofit with at least quarterly financial statements and most will provide them on a monthly basis. Make sure the statements are coming directly from the custodian of the accounts, NOT any outside financial advisor or board member who serves on the investment committee.

- **Wonder and then ask: who is watching the hen house?** An important factor in selecting an outside investment firm is who is auditing *them*? A tip-off for nonprofit leaders who resisted the high returns offered by Madoff's firm was that the auditors for the firm were a little known, small shop accounting firm that was not credentialed by the AICPA to conduct audits. (Also, the partner in the firm who conducted the Madoff firm audit was related to Mr. Madoff.) Nonprofits selecting professional fund managers should ask for information about the outside auditors of the investment firm, and should check the public peer review file of the auditing firm. That peer review process only applies to members of the AICPA. Some states also have separate peer review procedures which may produce reports that are available to the public for review.
- **It pays to check: take the nonprofit's financial temperature regularly**. Nonprofit leaders won't know whether the assets are up or down unless reports that offer a candid assessment of past and current performance are shared with the Board. The full Board is ultimately responsible for the protection of the nonprofit's assets, but a special task force that can focus on the immediate challenges, such as how the credit crunch may be impacting the nonprofit, is a good idea. Also, is someone monitoring the potential impact of investment losses on the current and future financial commitments of the nonprofit, such as 403(b) contributions, and plans for much-needed repairs and capital improvements?
- **It pays to plan: anticipate inquiries.** Keep in mind that if your nonprofit faces large investment losses, or even the threat of potential losses, there could be questions and scrutiny from stakeholders, the public, and the media. Be prepared by assigning a spokesperson in advance and making a commitment to openness and accountability, whether achieved through frank discussions with donors, web site statements, a press release, or annual report that candidly addresses investment performance. Many nonprofits are updating their donors with regular reports on how the financial crunch is impacting the nonprofit and what impact stock market losses have had on the nonprofit's endowments or other holdings.
    - *Preparation Tip*: Identify the five questions you'd least like to be asked in the midst of a finance-related crisis, and prepare your answers now!

The Nonprofit Risk Management Center welcomes your questions and comments at 703.777.3504 or info@nonprofitrisk.org.