

BOARD COMPENSATION AND CONFLICT OF INTEREST IN PRIVATE NON-OPERATING FOUNDATIONS

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Abstract:

This study investigates the board composition, compensation, and conflict of interest issues in 40 of the largest United States Not for Profit private non-operating foundations. A private foundation is one, which does not seek support from the general public and is generally a family or corporate foundation. A non-operating foundation is a foundation that makes grants to other not for profit entities and to individuals but is not directly involved in the activity.

Fourteen of the 40 foundations paid compensation to board members. Further, four specific instances of apparent conflict of interest are reported: two involving board members who were attorneys, one involving a board member who was a CPA, and one involving board members relationship to the foundation's investment advisor.

INTRODUCTION

In the public sector the role of the board and the auditor have come under increasing scrutiny and regulation since the well publicized scandals of WorldCom, Tyco, and Enron. Specifically, the Sarbanes-Oxley legislation has limited and regulated certain relationships.

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Recently, abuses have been reported at high visibility not for profit organizations such as The Statue of Liberty-Ellis Island Foundation, where reports of excessive salaries and poor management of investments made news¹ and United Way, where accounting methods were called into question.² These cases and others resulted in Congressional hearings and proposals for changes in laws governing not-for-profits and the role of the Internal Revenue Service in overseeing these organizations.

This paper looks at the board composition, compensation, and the practices of a particular subset of not-for-profit organizations – Private Non-Operating Foundations. These organizations, which generally take two forms – family foundations and corporate foundations - are characterized from other not-for-profit entities by two aspects. First, these foundations are private because the primary funding for the foundation was put in place at its creation and, in general, the foundation makes its grants and pays its expenses from the returns on the investment of these initial funds. Non-operating foundations do not seek public support through fundraising. Second, they are non-operating; such foundations generally make grants to other not-for-profit entities rather than being themselves directly involved (“operating”) in not-for-profit activities.

These organizations are generally not well known but command significant economic resources. Guidestar³, a not for profit database, reports that there are some 865 of these entities with income exceeding \$20 million each. At the minimal level of \$20 million each, these entities would command \$17.3 billion dollars annually, dependent on market performance of investments. Assuming an average 5% rate of return on assets, these foundations command approximately \$346 billion in total assets.

¹ McIntire, Mike. “Panel Faults Handling of Funds at Statue of Liberty.” New York Times: July 31, 2004.

² Strom, Stephanie. “Questions Arise on Accounting at United Way.” New York Times: November 19, 2002.

³ Guidestar. www.guidestar.org.

Private non-operating foundations are required to file an annual Form 990PF (Return for Organization Exempt from Income Tax – Private Foundation) with the Internal Revenue Service. This tax filing is a public document available upon request from the organization. The Form 990PF requires the Foundation to disclose extensive information, including: total revenues and sources, total expenditures by category, the membership of the Board of Trustees, trustee compensation, consultants paid in excess of \$50,000, highest paid employees, grants provided and committed in the reporting period, and other information.

PRIOR RESEARCH

While not for profit organizations in general have been the subject of considerable research, foundations have not received as much attention. The reason for this focus appears to be a greater level of research interest in those charitable organizations seeking to raise funds from the general public.

There is a limited research literature on the issues of board compensation and conflict of interest. In the area of board responsibility, Gibelman et al (1997)⁴ address the issue of nonprofit board credibility and responsibility following highly publicized cases of nonprofit malfeasance. They conclude that nonprofit boards face greater demands and challenges than they have in the past.

Fram and Withers (1999)⁵ consider the issue of conflict of interest from the perspective of trustees serving on potentially competing boards. Their conclusion is that such a circumstance is undesirable, but no need was seen for a public policy prohibiting such circumstances.

⁴ Gibelman, Margaret, Sheldon Gelman, and Daniel Pollack. "The Credibility of Nonprofit Boards: A View from the 1990's and Beyond." *Administration in Social Work*, Vol. 21, No.2, pp. 21-40.

⁵ Fram, Eugene, and Judy Withers. "Conflict of Interest in the Board Room? New Research Points the Way to Solutions." *Nonprofit World* Vol. 17, no. 2 (March-April 1999): pp. 19-21.

Bothwell (2001)⁶ surveyed “charity leaders and state regulators” about self-regulatory trends in not-for-profits. He finds evidence of increased activity of board governance in the wake of well-publicized scandals.

March (2002)⁷ reviews the diversity of nonprofit sector types and concludes that the IRC distinction between private foundations and public charities is essentially meaningless and should be replaced with a concept of donor control.

MacDonald et al (2002)⁸ provide a useful definition of conflict of interest and explore the causes and nature of conflict of interest in not for profits enterprises. They define a conflict of interest as “a situation in which a person has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties . . .” (p. 68). They further present a case study of a fictional foundation, but make no effort to provide conflict of interest cases from actual foundations.

The most comprehensive study to date on the issue of trustee compensation is the Georgetown Study (2003).⁹ This study looks at 176 large and 62 small foundations and provides research findings and tables on the frequency and scale of trustee compensation for the IRS fiscal year 1998. They found that, of large foundations, 64% compensated trustees in the period reviewed.

The present study extends this research in two areas. First, trustee compensation is defined more narrowly than in the

⁶ Bothwell, Robert O., “Trends in Self-Regulation and Transparency of Nonprofit Organizations in the U.S.,” *The International Journal of Not-for-Profit Law*, Vol. 4. Issue 1 (September 2001).

⁷ Marsh, Tanya. “A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities. *Virginia Tax Review*. (Summer 2002): Vol. 22 Issue 1: pp. 137.

⁸ MacDonald, Chris, Michael McDonald, and Wayne Norman. “Charitable Conflicts of Interest.” *Journal of Business Ethics*. (August 2002), Vol. 39, No. 1, pp. 67- 74.

⁹ Ahn, Christine. Pablo Eisenberg and Channapha Khamvongsa. “Foundation Trustee Fees: Use and Abuse.” Center for Public and Nonprofit Leadership, Georgetown Public Policy Institute. September: 2003.

Georgetown study, to include only those identified as trustees and excludes non-trustee executive directors. Second, this study specifically seeks to identify certain conflicts of interest from the public filings of the sample foundations.

SAMPLE SELECTION AND METHODOLOGY

This study looks at a sample of forty of the largest 865 private non-operating foundations in the United States. The board composition often followed a basic pattern – corporate foundations had a preponderance of corporate officers from the funding corporation on the board. Family foundations sometimes continued to have family members on the board but often did not have any identifiable surviving family members serving. It is not surprising that a certain level of nepotism was noted in the board composition of family foundations. The methodology employed was to identify the board, highest paid employees, and major consultants from the 990 PF filing and then to attempt to trace each board member through an internet search to see what other affiliations that individual might have. Generally, since these were the largest foundations, board membership was sufficiently prestigious that 82.3% of the board members identified (251 of 305 board members) could be readily traced through Internet sources to find biographical and/or affiliation data.

Private non-operating foundations are taxed with an excise tax amounting to 1% of their annual revenues. Since such foundations are not a source of substantive tax revenues, it is likely that the Internal Revenue Service expends only nominal funds in monitoring compliance. As a result, these foundations are free to function and set policies with minimal oversight. Recent federal legislation, such as Sarbanes-Oxley, relates only to publicly traded firms. It would seem that such private foundations, with substantial resources and minimal oversight, constitute a potential arena for unethical behaviors and conflicts of interest.

A random sample of foundations identified by Guidestar® as private non-operating foundations with income exceeding \$20 million was chosen. This definition in Guidestar® proved to be

substantially misleading in the year under study (fiscal year beginning in 2002, as defined by IRS filings). Of the 40 foundations identified, only six had revenues exceeding \$20 million and three had losses exceeding \$20 million in that year. As a result, three criteria were chosen to retain a foundation in the study: the foundation needed to be large, active and have a continuous existence. These measures were operationalized as follows:

- Large was defined as fair value of assets exceeding \$20 million,
- Active was defined as a minimal total of expenses and disbursements of \$1 million, and
- Continuous existence was defined as a prior existence of at least one year.

As a result, six foundations were excluded from the final sample and substitutions made. Of these six, two were deleted because they did not meet the criteria of large (fair value of assets was below \$20 million); an additional four foundations were deleted as inactive (total of expenses and disbursements less than \$1 million). One of the foundations in this inactive category was also a newly filing foundation so did not meet the criteria of continuous existence. Significantly, this particular foundation listed assets and contributions of \$1.9 billion with no expenses or disbursements. Additionally, the 990PF filing itself was deficient in many respects. The foundation listed one (uncompensated) board member. An Internet search on this individual indicated that he had been the subject of SEC sanctions in the past.

One additional foundation was subsequently deleted with substitution. This foundation failed to meet the “non-operating” criteria of the IRS although it was classified as such. It appeared that this foundation had begun as a non-operating family foundation but had subsequently taken over the operations of a large metropolitan hospital on a not for profit basis, and thus is now an “operating” foundation.

Of the 40 private non-operating foundations, thirty-three were identified as family foundations and seven as corporate

foundations. A family foundation is one in which an individual, or often a married couple, donated, or provided in a will, significant funds to establish the foundation. Predictably, the main source of operating funds here is the earnings on investments or drawing from the corpus of the fund itself. A corporate foundation is funded by a corporation and generally receives considerable contributions from the corporation on an annual basis to supplement earnings on investments. While most family foundations are, or were, indirectly related to a corporation as often the initial contributor made his fortune by founding a corporation, the family foundation receives no contributions from the corporation.

Table 1 presents some descriptive statistics concerning the sample:

Table 1
Descriptive Statistics on the Sample

	Family N = 33	Corporate N = 7
Median number of trustees	6	8
Median Total Assets	\$57.2 mill	\$46.3 mill
Median Revenues	\$545 K	\$5.6mill
Level of Grants to Operating Expenses	\$5.55	\$8.93
Mean		
Median		
Ratio of Grants to Total Assets	5.1%	8.9%

As indicated in Table 1, the median total assets of the family foundations in the sample were \$57.2 million (range \$25 million to \$1.1 billion), while median assets of the seven corporate foundations were \$46.3 million (range \$24 million to \$2.8 billion). Median revenues show a substantive difference between family foundations (median revenues of \$545 thousand, range \$(36

million) to \$86 million) and corporate foundations (median revenues of \$5.6 million, range \$(65 million) to \$56 million) due to the contributions received as indicated above. In the period of the study, seventeen of the 40 foundations had negative revenues due to market returns on investments.

Median operating expenses for both family and corporate foundations were about 1% of total assets. The median level of grants to operating expenses was \$5.55 for family foundations and \$8.93 for corporate foundations. This means the median family foundation incurred \$1 of operating expense for each \$5.55 of grants awarded. The range for family foundations was from \$0.56 (or operating costs of \$1.79 for each \$1 of grants) to \$39.41. Only one foundation reported a higher level of operating expenses than grants made. This foundation reported a substantial cost for settlement of litigation and additionally a high level of interest expense in the year of the study. Although the nature of these costs were not disclosed in the IRS filing, it seems likely that the interest related to the litigation settlement and that the litigation was tied to the company from which the founder had derived the wealth he had bequeathed to the foundation. The relative level of grants made to operating expenses is a significant benchmark in viewing how foundations meet their objectives. Table 2 presents overall statistics on this measure.

Table 2
Grants Paid to Operating Expenses

<u>GRANTS PAID TO OPERATING EXPENSES</u>	FAMILY FOUNDATIONS <u>N = 33</u>	CORPORATE FOUNDATIONS <u>N = 7</u>
Less than \$1.00	1	0
Between \$1 - \$2	1	0
Between \$2 - \$3	5	1
Between \$3 - \$4	7	0
Between \$4 - \$5	2	0

Between \$5 - \$6	3	1
Between \$6 - \$7	3	1
Between \$7 - \$8	1	0
Between \$8 - \$9	2	1
Between \$9 - \$10	2	0
Over \$10	6	3

Current IRS requirements for private foundations mandate that the foundation pay “qualifying distributions” in an amount equal to 5% of the fair value of certain average assets held throughout the year. However, this amount can be adjusted upward or downward in any year based on the foundation’s prior disbursements. Failure to comply with this requirement over an extended period results in a penalty tax to the foundation. Qualifying distributions include both grants and operating expenditures. In the year of this study, family foundations’ median expenditures for grants alone were 5.1%, for corporate foundations, 8.9%.

BOARD COMPOSITION AND COMPENSATION

The median number of trustees for family foundations was six, for corporate foundations was eight. The range was from one board member, a bank serving as sole trustee for a family foundation, to 30 board members for a family foundation. In the latter case, twenty-six of the thirty were identified as family members. The Senate Finance Committee’s white paper on reforms for exempt organizations¹⁰ proposed limiting board size to no more than fifteen members. Derek Bok, former president of Harvard University, however, argued against this proposal noting that more members might be necessary to adequately staff board

¹⁰ Senate Finance Committee. “Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities.” Washington D.C.: 2004.

subcommittees.¹¹ Application and adaptation of provisions of the Sarbanes-Oxley Act might require foundations to establish audit committees. Of the 40 foundations analyzed here, only one explicitly noted the current existence of an audit committee.

Of the thirty-three family foundations, thirteen (39.4%) paid some compensation to a board member. The Boston Globe¹² reported as an abuse a foundation board member who tripled his board compensation following the death of the last family member. Significantly, in this study, twenty-three of the thirty-three family foundations (69.7%) had family representation on their boards. Of these foundations, six (26.1%) paid compensation to at least one board member. Of the ten foundations, which did not have family representation on the board, seven (70%) paid compensation to at least one board member. A high negative correlation here between payment of compensation to board members and family members on the board is suggestive and a Mann-Whitney U-Test indicates significance at the 10% level. Size of the foundation was unrelated to whether or not the board was compensated.

For family foundations, the maximum compensation paid to a single board member in this sample ranged from \$0 (17 foundations) to \$500,000, which was paid to the son of the founder who also reporting working 40 hours a week for the foundation. Of the six family foundations with family members participating on the board who compensated at least some board members, five of these also compensated the family members serving on the board.

The Sarbanes-Oxley Act stressed the need for outside directors. In foundations, the role of president and/or executive director is somewhat problematic. For purposes of this study, the individual listed as executive director was not considered to be a board member. This appears consistent with the limited number of foundations who provided separate listings of the board. In these

¹¹ Bok, Derek. "Testimony of Derek Bok." Senate Finance Committee. Document 2004-12925. Washington D.C.: 2004.

¹² Pfeiffer, Sacha and Michael Resendes. "Foundation Lawyers Enjoy Privileged Position." Boston Globe: December 17, 2003.

cases, it appears that the executive director was the operation head of the foundation, generally the highest paid employee, but not a member of the board. The IRS 990 PF filing requires a listing of the “officers, directors, and trustees” without specification. Best business practices would suggest that the executive director, the individual in charge of day to day activities, answer to the board and therefore, not be a member of the board.

Of the seven corporate foundations, six used corporate officers for board members. Only one board had any compensated board members. By contrast, five of the seven foundations employed an executive director. The highest payment to an executive director in a corporate foundation, including deferred compensation and expense accounts, was \$511 thousand.

Of the thirty-three family foundations, ten paid no compensation to the board or to an executive director (30.3%), and another ten paid compensation only to the board members (30.3%). Ten foundations paid only an executive director (30.3%). Three paid both board members and an executive director (9.1%). This latter finding suggests that boards were more likely to be compensated if there was no executive officer to run day to day operations, requiring the board members to take on the role of running the foundation. The highest paid executive director in a family foundation received compensation totaling \$294 thousand.

Compensation levels of board members and officers of not-for-profits has been a topic of interest in the press.¹³ The IRS position, however, is ambiguous. From the IRS perspective, compensation is not excessive if deemed “reasonable.” The rule applied is “reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances.”¹⁴ The IRS has conceded in public testimony that

¹³ Boston Globe, *op. cit.*, New York Times (2), *op. cit.*, Shatzkin, Kate. “Some Foundations Spend Lavishly on Own Board Members.” Baltimore Sun: May 11, 2003.

¹⁴ Miller, Steven T. “Easier Compliance Is the Goal of New Intermediate Sanction Regulations.” IRS: Washington D.C.: 2001.

it does “not impose penalties as often as it should” in the area of excess compensation in not-for-profits.¹⁵

In three cases, a bank served as a trustee rather than a specific individual. In all three cases, the bank was compensated for these services with compensation ranging between \$100,000 and \$650,000. The role the bank served was not completely disclosed in the Form 990 PF.

The Georgetown Study¹⁶ questions the need for trustee compensation at all in large prestigious foundations. That study notes that “the overwhelming number of foundation trustees are either wealthy or highly paid professionals who can easily afford to volunteer their services (p. 3).” This study also notes “there is little evidence that paying fees to trustees is an essential part of successful foundations and grant making (p. 20).”

CONFLICT OF INTEREST

Of the 40 private non-operating foundations surveyed, four exhibited aspects that at least provided the appearance of conflict of interest.

Audit: One foundation board member, receiving a significant (over \$25,000) stipend as a board member appeared to have been a founding partner of the CPA firm performing the audit. Recent legislation affecting public companies, the Sarbanes-Oxley Act, prohibits management members of the firm’s CPA firm from assuming positions of authority with a client for effectively two years after leaving the CPA firm. In this case, it was not possible to determine at what point the former partner had left the CPA firm nor was it clear when he had joined the board of the foundation. Although he was a founding partner, and the firm still maintained his name in the firm name, he was no longer listed as a member of a firm. The fact that this individual is a paid member

¹⁵ Stokeld, Fred. “Senate Finance Hears Testimony on Nonprofit Abuses.” Planned Giving Design Center. 2004.

(www.pgdc.com/usa/print_item/?itemID=224245).

¹⁶ Ahn et al, op. cit.

of the board of the foundation, and his name also appears in the name of the CPA firm conducting the audit, affords at least the appearance a conflict of interest.

Legal: Two instances were noted where members of the board were affiliated with law firms which also received payment for legal services provided to the foundation.

In one instance, a board member was the managing partner of a large regional law firm, which received over \$1 million in fees from the foundation. Although the board member was uncompensated for his service on the board, his law firm provided management, accounting, and legal, services to the foundation. These fees constituted over 50% of the operating and administrative expenses of the foundation.

In a second case, two board members of a foundation were partners in a large national law firm, which also provided services to the foundation. The two board members were compensated (over \$10,000 each) but the fees to the law firm were only approximately \$4,000.

Investment Management: One foundation had a complex inter-relationship with their primary investment management consultant. This was a family foundation where the primary investment advisor was the former husband of one board member and the father of another. These board members were also family members, bearing a direct hereditary relationship to the individual who started the foundation. To further complicate the relationship, the son of the investment advisor was also employed by his father's firm. The investment advisor's firm, an internationally known investment management firm, charged the foundation fees in excess of \$2 million.

It is significant here that four of the 40 foundations (10%) exhibited some aspect of a direct conflict of interest. There are three limitations to this study from the perspective of documenting conflicts of interest, which would suggest that the issue of conflict of interest might be more widespread. First, most not for profits either did not provide a website or did not provide biographies of their board members. In most cases, board member biographies

and affiliations were found through an Internet search. This resulted in identifying 82.3% of the board members in the study. The biographical data and affiliations of the remaining 17.7% are unknown. Second, nearly half (45%) of the foundations in this study did not identify all accounting, legal, and investment management consultants receiving less than \$50,000 per year by name. Third, this study made no attempt to identify or examine what might be defined as secondary conflicts of interest. A secondary conflict of interest would represent a situation where a board trustee directs grants from a foundation to another not for profit (e.g., a college) when the other not for profit is a client of his firm. The Boston Globe article (op. cit.) cited a number of such secondary conflicts of interest.

IMPLICATIONS

In mid-2004, Congress held hearings concerning what were viewed as abuses by not-for-profits. As a result, the Senate Finance Committee produced a discussion draft relating to the governance of charitable organizations. These recommendations included:

- A review of each organizations tax exempt status on a five-year basis.
- A consideration of requiring that foundations trustees or directors serve without compensation. As noted, in this study 14 of the 40 foundations (35.0%) compensated at least one board member.
- A consideration of applying a rule that would limit employee salaries of foundations to federal government rates for similar positions.
- Require each not-for-profit to maintain, or make available on, a website certain operating information. In this study only 12 of the 40 foundations maintained a website.
- Require the CEO to sign the 990 to certify accuracy and completeness of the return.

- Mandate that an audit be performed and require auditor rotation similar to the requirements of the Sarbanes-Oxley Act.
- Increase the disclosures required in the form 990
- Limit Board size to no less than three or more than fifteen members.

In this study, 4 of the 40 foundations had less than three trustees (the smallest board being one member, a bank), and four also had more than fifteen trustees (the largest board being 30 members)

The American Institute of Certified Public Accountants (AICPA) commented on these drafts in a white paper of July 22, 2004¹⁷ (AICPA, 2004). In general, the AICPA argued that cost benefit and other considerations would make many of these recommendations a burden to not-for-profit organizations.

In this study, all 40 foundations clearly disclosed the source of any donations and earnings and provided data on each grant paid. Compliance in this area was 100%. IRS regulations require that only consultants paid in excess of \$50,000 be disclosed. All foundations in the sample complied with this rule. Fifteen foundations reported no consultants in excess of \$50,000. Five reported paying more than five consultants in excess of \$50,000. Of the forty foundations in this sample, only 16 disclosed the names of consultants paid less than \$50,000. An additional six foundations disclosed some but not all by name. The remaining 18 foundations reported such consulting expenses only functionally (e.g., “legal fees,” “management fees,” “accounting fees”).

Twenty-one firms disclosed the detail of the investments they were holding at the end of the year. The remaining nineteen disclosed only gains and losses.

¹⁷American Institute of Certified Public Accountants. “Comments on the Senate Finance Committee Discussion Draft Relating to Charitable Governance.” AICPA: July 2004.

Findings in this study indicate significant differences in the area of board compensation. Many board officers served pro bono, but a significant number did receive compensation, sometimes substantial, for their services as a board member. In several instances, board members who served with compensation also exhibited certain conflict of interest issues.

Certain suggestions are made below to improve IRS reporting.

- The form 990PF currently requires foundations to indicate “title and average hours per week devoted to position” for “Officers, directors, trustees, and foundation managers” together in Part VIII. However, despite the specificity of this line item, in this sample only 21 foundations (52.5%) complied with the time reporting requirement. Of the remaining 19 foundations, time reporting in this section was as follows:

<u>Description of time</u>	<u>Number of foundations</u>
“as needed”	5
“as required”	3
“part time”	3
“none”	2
“varies”	1
“percentage”	1
“board meetings”	1
No response	3

- Requiring that board members (“directors” or “trustees”) be reported separately from the “officers” and “foundation managers” and explicitly defined as board members would improve reporting. This failure to report separately leads to difficulty in interpreting the role and compensation of the board versus officers of the foundation. In this study, only 14 of the forty foundations (35.0%) reported paying board members as defined here. This contrasts sharply with the Georgetown Public Policy Institute study (2003),

which reported that 64% of large foundations paid fees to board trustees. The variance, however, is due to the definitions in the studies. The Georgetown study considered executive directors reported in Section VII as board members. This study excluded this title, considering this individual to be an officer rather than a director or trustee. This latter interpretation was consistent in all cases where the foundation provided a separate listing of board members. It is also consistent with recommended governance procedures, which indicate that the executive director should answer to the board, a difficult situation if that individual is also a member of the board. If executive directors were considered compensated board members in this study, the rate of compensation would rise to 60.0%, consistent with the findings of the Georgetown study.

- The IRS should consider adopting a modified version of the American Institute of Certified Public Accountants ethical rules on independence. In this study, four potential instances of direct conflict of interest were noted. The press has cited a variety of cases where secondary conflicts of interest were apparent. The IRS should require disclosure of direct relationships, such as those cited in this study, and also require “related party” type disclosure of secondary relationships.
- The IRS should consider requiring disclosure of the names of firms or individuals providing accounting, legal, and investment advisory services whether or not the cost of such services exceeds the \$50,000 limit currently in place. Such disclosure would facilitate the discovery of potential conflicts of interest.
- The IRS should consider requiring the reporting of self-monitoring ratios other than the currently required 5% payout ratio computation. For example, this study and others have looked at the ratio of grants awards to administrative costs and trustee and other compensation. Such ratios provide early warning signs of potential abuse.

Finally, it appears that the area of not-for-profit organizations is a rich area for research into potential compensation abuses and direct and indirect conflicts of interest. Future research might concentrate on other types of not-for-profit organizations and also consider indirect conflicts of interest.