

SOXed Again?

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from Post-Crisis Corporate Boardrooms

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After the 2002 passage of The Sarbanes-Oxley Act (SOX) by Congress, a shock wave rumbled through the independent school, college, university and non-profit worlds. Many wondered how the new demands for operational transparency, record-keeping, audit committee independence and whistle-blower protection would affect their institutions. Would donors expect the nonprofits they support to comply with the new law despite the narrow focus of the legislation on publicly traded companies?

Associations for nonprofit executives and educational leaders built their annual meetings around these topics and legal papers with titles like: “The Sarbanes-Oxley Act and Implications for Nonprofit Organizations”ⁱ were eagerly read and discussed. Remembering the sweeping ramifications of the Americans with Disabilities Act (ADA), which was signed into law a little over a decade earlier, nonprofit leaders braced for more sweeping changes to how they operated.ⁱⁱ

For those of us in independent schools, the ADA came as a bit of a surprise. In the late 80’s, when the legislation was working its way through Congress, few in the independent school world understood its full implications. However, once law, the ADA affected every building project or major renovation schools undertook. ADA compliance became a significant line item in every construction project. While there was no resistance to the intension of the law, there was a palpable sense of intrusion into the freedom we once enjoyed. Many warned, SOX would have a similar effect on nonprofits despite the fact that SOX was not written to include institutions with an IRS 501c 3 designation.

Unlike the ADA, which had a civil rights focus, SOX was intended to redress the Enron and Tyco-type scandals which were rooted in accounting fraud and governance irregularities. The nonprofit and school worlds were not immune to problems in these areas. Prominent institutions like the United Way of Washington, D.C., the Milton Hershey School and Adelphi University, all had made the news with management lapses involving executive compensation packages, management of endowment and conflict of interest issues. It was not difficult to imagine that legislation which extended the reach of SOX would be coming soon. Although legislation mirroring SOX for nonprofits has yet to develop at the federal level, accounting rules have been changed and many other of the provisions of SOX have significantly shaped how independent schools conduct their financial operations.

In the wake of the recent financial crisis, there has been a public outcry for regulatory changes to prevent the excesses and outright fraud that have been uncovered in the financial and banking industries. The crisis has brought into high relief the importance of good governance.

A glimpse into what is beginning to emerge in the regulatory area was recently shared with the consultants of Heidrick & Struggles International. On a global conference call, consultants were briefed on some of the changes under consideration by the Securities and Exchange Commission (SEC). One possibility would require not only more complete disclosure of proposed Board members' backgrounds in advance of election to boards, including directorships within five years in public companies, but also a justification for their election to the Board.

It is no revelation to independent school leaders that getting people to serve on boards of trustees has become more difficult. A major contributor to this reluctance has been the increasing amounts of litigation aimed at schools. When a school is sued, the board is usually sued; often board members are named individually in a suit. Directors and Officers insurance (D&O) and indemnification provisions do not prevent lengthy and often very public court battles. The prospect of adding a public vetting by stakeholders of a board nominee's credentials and fitness to serve would increase the chill on the already waning enthusiasm some of our best board nominees are feeling.

To many parents and alumni, how certain people get chosen for the board of an independent school board is no less mysterious than how corporate board members are chosen. The procedure for nominating a board candidate is rarely delineated to stakeholders of the school and the process is usually not public in any way except in its result. Also, the Head of School, particularly if a long-serving leader, is frequently seen as exerting extraordinary influence on the process.

Independent school boards, which have a large population of current parents, face another complication. Current parents on a day school board play a pivotal role in setting the tuition rate for the very service they are contracting from the school. Because most schools set tuition below the total calculated cost of providing the education and rely on tax deductible Annual Giving gifts to close the gap, the appearance of conflict is even more pronounced. While this potential conflict has been traditionally accepted, it might not be once new regulations begin to reshape corporate board selection procedures and those new procedures become accepted practice.

Although impossible to predict with certainty what the end result will be, an increased role for stockholders in the selection of corporate board members is most certainly on the horizon. In fact, President Obama has even mentioned the idea of stockholders having a say in setting CEO salaries. Once the dust settles and a larger involvement of stockholders becomes an accepted part of the American corporate culture, schools may find the secretive trustee nomination and selection process at odds with best practices in America's boardrooms, and thus, at odds with the expectations of the school's supporters.

The prospect of a public vetting of nominees to independent school boards is not desirable. Boards must be free to elect trustees who can further the mission of the school as the Board defines it, and be free to add board members even if the major contribution of those board members is financial.

How can independent school boards stay independent, yet increase their accountability and transparency? How do we avoid the speculation that surrounded SOX and the subsequent scramble to comply with new regulations? In short, how can we avoid being SOXed again?

First, independent school boards should spend time reflecting on their current operational assumptions in the context of a changing corporate boardroom culture. The central issues driving the regulatory changes under consideration are an increased interest in governance transparency and the desire for reassurance that those making decisions are doing so with the best interest of the institution in mind. This reassurance must be substantive. Some school boards have attempted to pull the curtain back on the mystery surrounding the board's operations by providing opportunities for stakeholders to get to know board members personally. Get-to-know-the-board events are laudable; but, in fact, stakeholders really want to know more about what the Board is thinking and doing rather than just who they are.

Second, a review of school websites reveals an uneven approach to information shared with stakeholders about the Board. At the minimum, board members should be listed on the school's website and a mailbox established for stakeholder comments to the Board. This mailbox should be monitored and a systematic effort made to respond to messages.

Third, boards would be wise to post summary actions of meetings, appropriately redacted of confidential information, which convey a sense of the Board's work and issues under consideration. Describing the work of committees charged with reviewing such things as disciplinary and personnel policies and practices would be a productive step toward reassuring stakeholders that the Board is actively involved in governance. These postings could be educative as well, underscoring via concrete examples, the appropriate distance a Board should maintain from operational involvement.

Fourth, open a place on the school's website for confidential nominations to the Board from stakeholders. This section should provide for the justification for the nomination as well as the qualifications of the individual. The Nominations Committee or Committee on Trustees should only promise to receive and consider these nominations. However, opening this avenue will positively contribute to eliminating some of the capriciousness associated with the nominations process.

Fifth, Boards should provide for representation from those who are not connected to the school in any way, but who are respected leaders and experienced trustees who have served other institutions. This public gesture of seating "neutral trustees" would acknowledge the Board's commitment to ensuring objectivity in decisions and an

unencumbered voice for best practices in all decisions. One source of these pre-vetted trustees is the Chief Advisor Network available through Heidrick & Struggles.

Finally, independent school boards need not recreate the wheel. Corporate boards are increasingly being proactive about risk management and discussing ways of taking advantage of new opportunities presented by the changing economic landscape. They are challenging their old ways of doing business and engaging in conversations about talent management and the restructuring necessary to effectively move forward in a different economic environment. All these areas are good topics for independent school boards. At the very least, these are topics where increased communication from the Board would be worthwhile to the people who care about and support the institution and who maybe wondering about its future.

The corporate board room is undergoing significant change in response to the current crisis of confidence in governance. A wait and see posture on the part of independent school boards or a reluctance to question accepted operations of the board will not prepare our schools to emerge from this current crisis with the confidence of the stakeholders we depend upon for the future success of our schools.

For information about best practices in governance consulting and executive search contact:

George E. Conway

Principal, Education and Social Enterprise Practice

Heidrick & Struggles

2001 Pennsylvania Ave

Suite 925

Washington, D.C. 20006

gconway@heidrick.com

+1 202.331.4910

ⁱ Board Source and Independent Sector paper published in 2003, revised in 2006.

ⁱⁱ ADA was signed into law by President George H. W. Bush on July 26, 1990