

# Who Does It Better?

## The Corporate versus the Nonprofit Governance Model

**A**lthough Sarbanes-Oxley and the NYSE standards may have raised the bar for public governance behavior, “best practices” for corporate boards cannot be transferred automatically to health care and other nonprofit boards. The consensus among the experts is that both models have their strengths and flaws—and lessons to take from each other.

“Each type of board has something to learn from the other—neither has the corner on delivered wisdom,” says Knox Singleton, president and CEO of Inova Health System, Falls Church, Va. Singleton has served on both corporate and nonprofit boards.

“When you look at three glaring examples of horrendous for-profit governance—Enron, Worldcom, Disney—you see how the board’s [role] as a countervail to administration and an advocate for shareholders broke down—and I don’t think Sarbanes-Oxley fixed that,” says Jeff Goldsmith, president of Health Futures Inc., Charlottesville, Va. “Just because there is more transparency, independent directors and separation of the CEO and chair’s roles ... that helps, but the reality is that management simply does what it chooses.... [Sarbanes-Oxley] just creates another layer of processes to be managed ... it’s another layer of process that can be subverted.”

Litigation has still proved a powerful teacher, however. “I think for-profit boards have learned that what they do matters, that you are personally liable if you don’t do your job—and both private and public boards can expect more attention from shareholders and government agencies [looking at] your performance,” observes Paul Lapidès, director of the Corporate Governance Center and Assistant Professor of Management and Entrepre-

neurship at Kennesaw (Ga.) State University. “Did you collect the appropriate information to have a reasonable discussion to make a decision? Did you put the company first? When directors get sued, they become trained to become experts on these issues—but why not teach them first?” Lapidès adds, however, that if trustees don’t really know what they’re asking, they won’t gain any insights. Boards must do their homework and truly understand their business in order to govern intelligently.

“In most of these corporate scandals, if the directors had done more [investigative] work, they would have seen what does and doesn’t make sense,” Lapidès says. “Directors should not get puffed up about the success of their company—that [success] should increase their monitoring.”

### Gonzo Management

Board passivity, combined with executive overdrive, have been the culprits in the corporate world, Goldsmith believes. “Enron wasn’t just about greed—the board was captured,” he says. “A predatory corporate culture overwhelms all forces of accountability.” He thinks the highly complicated nature of Enron’s business, combined with a steamroller management style, left directors in the dark—and ultimately liable.

By Laurie Larson



"Corporate boards are just beginning to get around to doing what they should have done a long time ago," Goldsmith says. "They are still very beholden to management and don't function as effectively [as they should] as advocates to shareholders, bond holders and the customers' interests. Charismatic management will still overpower the board."

However, nonprofit health care boards have the same issue, he believes, and "have not been effective stewards of community resources." The days of regarding nonprofit boards, and health care boards in particular, as philanthropic, where serving as a trustee was an "emblem of community leadership and a guardian of the social capital of the institution," as Goldsmith describes it, are gone. "[Boards need to ask] 'Are we able to produce a return to the community that we can quantify?' People are looking for evidence that there is community benefit—is the hospital putting something back?"

Since the 1970s, Goldsmith estimates, CEOs have realized that they need more experienced trustees, but he adds, "it's only a partial evolution." Health care boards are now well aware that they are responsible for overseeing management's effectiveness in running the institution for the community's benefit. But just as in corporations, the larger or more disorganized the board, the less likely it will be to hold management accountable for the appropriate deployment of resources, he believes.

"Management can still get the board to go along," Goldsmith says. "That's what happened with AHERF. The board was captured by management and driven hard off a cliff." He points out that one firmly opposed board member was ejected from the board in the middle of it all ... "the parallels with Enron were striking."

## Margin or Mission

Nonetheless, responsible governance for community benefit is more difficult to prove than responsible corporate governance, and therein lies the biggest difference between for-profit and nonprofit boards, Singleton believes.

"The nonprofit board has to make decisions that balance mission with the bottom line," he says. "Corporate boards don't have those trade-offs—there is no mission beyond making money. Mission equals the bottom line in the corporate world."

To focus on financial performance to the exclusion of all other indicators is inappropriate for nonprofit boards, Goldsmith says, but the overall accountability to stakeholders is the same. "Health care organizations are more complicated than corporations, and what they do is more complicated, but to use that as an excuse [for poor governance] is no good," Goldsmith says.

However, Espen Eckbo, founding director of the Center for Corporate Governance at the Tuck School of Business, Dartmouth College, Hanover, N.H., thinks the distinction is meaningless. "Nonprofit boards should forget they are nonprofit," Eckbo asserts. "They should emulate for-profits [because] their job is the same—to maximize the pie, maximize resources. The distinction is really in terms of who gets the dividend." In for-profit companies this means shareholders, he says, and in nonprofits, the "dividend" is put back into the organization.

## What Corporate Boards Do Best

Still, organizational goals that can be spelled out on a balance

sheet often do give corporate governance an edge.

"Having served on both kinds of boards, I think you see a lot more for-profit effectiveness relative to financial oversight," says Roger Raber, president and CEO of the National Association of Corporate Directors (NACD), Washington, D.C. "That's easier on for-profit boards because their single focus is shareholders—they keep you on your toes" since directors of for-profit corporations represent stockholders who expect a return on their investment. Also, corporate boards must all have independent audit committees that now must comprise at least one financial "expert."

Raber does not specifically recommend that nonprofits follow that example, but he does agree that nonprofits "could do better to get more background and sophistication in understanding accounting" and should seek greater financial expertise. "There is no excuse for financial illiteracy. Don't [join] any board if you are financially illiterate in today's environment," Raber says.

Goldsmith believes corporate boards are also better with succession planning and management performance evaluation than nonprofit boards. This includes the use of more advanced dashboard indicators and tying compensation to performance.

Nonprofits, on the other hand, have more of a "renter culture" Goldsmith says, not treating the organization's assets as their own. In this case it is "political capital" that must be put on the table to govern, i.e., demanding accountability on less concrete issues, Goldsmith says, and "most people don't want to do that. A lot of nonprofit board members are still not comfortable being in charge of corporate performance."

Although Singleton agrees with Goldsmith that nonprofits may be reluctant to "take up the difficult issues" of conflict of interest or difficult strategy decisions, he also thinks, when the situation is less thorny, that health care trustees in particular, may get too involved in operations. Hospital trustees could learn from corporate boards "to stay more at the director level—don't reach down into management," Singleton says. "Corporate boards are more assiduous about respecting the role boundaries of being a director." He adds, "the focus [for nonprofit trustees] needs to be at the strategic and assessment level. Too much nonprofit board time is spent on operations and not enough time is spent on the strategic direction of capital."

Uncertainty about who owns the organization creates the greatest weakness for nonprofit boards, Eckbo says. "The key issue for all boards is [determining what its] correct objectives are. That boils down to who owns the firm. [Nonprofit boards] have more diffused objectives—they don't have the shareholders' focus. There is less pressure to perform ... it's harder to determine values."

"Nonprofit boards don't have falling stock prices to deal with, so they can avoid dealing with tough issues longer ... wishful thinking (i.e., passively hoping that conditions will improve) happens more," Singleton says. By contrast, corporate directors have to respond quickly to their company's losses and face greater pressure to do so.

Or do they? Passivity isn't exclusive to the nonprofit world, Eckbo says. In the corporate world, it lies with shareholders.

"This is part of the breakdown of governance in for-profit companies," Eckbo explains. "When shareholders in the corporation are passive, management can absorb [their] rights and

exercise them on their own.”

As Eckbo explains it, corporate management chooses board candidates and sends the nominations out to shareholders, who may either approve or abstain from voting. Too many do the latter, he believes. “If 99 percent of shareholders abstain from voting, then management has driven the election ... the governance function has drifted,” he says. Eckbo thinks one solution, which the Securities and Exchange Commission plans to propose, would be to add a proxy vote to shareholders’ ballots, to write in additional nominations.

“I personally blame the whole breakdown of the [corporate] board system to shareholders not voting,” Eckbo says. “If shareholders could really vote their candidate in, they could fix it.”

## What Nonprofits Do Best

By contrast, Lapidès finds health care board trustees are usually very well-informed about the board’s business and ask insightful questions.

“There is such a thoughtful group of people in the health care business,” Lapidès says. “They understand the importance of serving constituents well ... they know it’s good business to listen to employees, patients and [stakeholders] ... the motivation of being in health care is to make people better.”

He applauds health care boards’ openness to customer feedback, as well as anonymous whistleblower hot lines, a mechanism health care organizations had in place years before it became a requirement for public companies.

Singleton also thinks corporate boards could take a lesson from nonprofits in their separation of board chair and the CEO roles and the comparative independence of trustees and board leadership.

“The vast majority of nonprofit boards have already complied with the majority of Sarbanes-Oxley independence requirements ... many recommended best practices have been ‘old hat’ in nonprofits for years,” Singleton says.

A greater attention to independence and conflict of interest has long been a strong suit of health care boards, a strength for-profits are now striving to match. For profit companies have always had more “inside directors,” those with direct financial links to the organization.

“Inside directors are one of the biggest inherent conflicts for for-profit boards,” Singleton says. “Five years ago, a corporate board might have three to four inside directors on a nine member board ... that’s changing now.”

Eckbo says that “it is very important that inside representation be minimized on the board. Independence breaks down the power struggle between management and the board.”

On the other hand, Lapidès thinks that the rallying cry for independent directors has been overblown. “Most observers of governance are now in agreement that we’ve gone too far with

independence,” Lapidès says. “Having only independent directors doesn’t make sense. They have no connection to the company and no interest, so they bring the least to the company. Experience and knowledge are invaluable even with potential conflict of interest.”

That’s why a mix of independents and insiders is best, he believes. To “balance out the constituencies ... there should be enough independence that insiders don’t make all the decisions,” he explains.

Still, Raber insists, “governance is governance, more or less. The integrity required of both kinds of boards is the same—the ability to ask the tough questions.”

And regardless of the number of independent directors on a board, all boards should also share “independent-mindedness,” Raber says, keeping a focus on the mission and interests of the whole organization. And all trustees, corporate or nonprofit, are by definition, accountable for the organization’s performance and integrity.

## Size Does Matter

Board size is also a major factor in efficient board decision-making, and here, for-profits may have the edge.

The board with ultimate authority should be between eight and 12 directors, Raber recommends. Singleton believes corporate boards often outperform nonprofit boards because of their smaller size. “Large boards have no personal accountability, no ownership. A 30-member board is fairly anonymous,” Singleton says. “Too many boards retreat into the simplistic question [of asking] ‘Is the organization making money or not?’” Opinions or comments on strategy often don’t even enter into the picture.

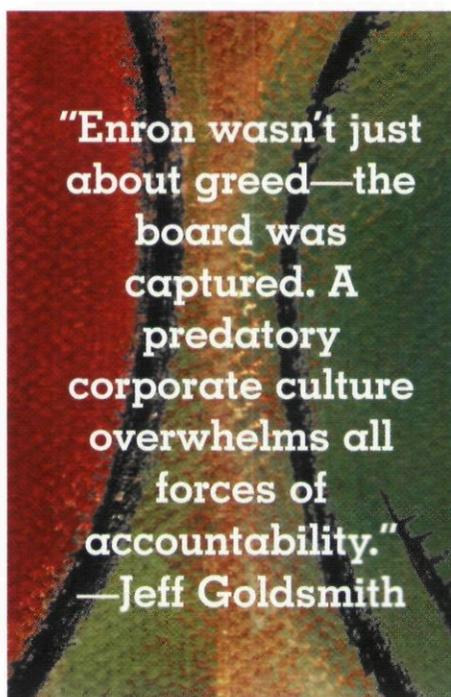
However, Raber believes corporate boards are also much better at achieving “consensus over compromise” because of both their clear goals and generally

smaller size. “In the nonprofit world, there are lots of constituencies who are pulling your strings” as a board member, Raber says, and when too large a board tries to please too many people, there is often dissatisfaction among board members who feel they have “given up” their choice to go with the group vote.

“Compromise doesn’t work because it’s less than adequate for all,” Raber says. “It has to be consensus because that creates ownership.” Raber also admits, however, that the goal for consensus is much more clear-cut in corporations, and the choice to stay small is easier without the community representation that health care boards often feel is necessary.

This is where he recommends creating an advisory board to bring in the concerns of the nonprofit organization’s many constituencies, without bogging down the voting work of the hospital or system board.

Lapidès agrees. “It’s hard [to have] the biggest activists in a constituency on the [regular] board—those with an agenda. Advi-



sory boards are a way to include the community and contentious people without [them] getting into topics they may not understand." Boards also need to realize however, that the public doesn't really understand—or care—about the difference between for-profit and nonprofit. "They only ask 'Are you representing our best interests?'" Raber adds.

It all boils down to the board defining its role, Goldsmith says. "Boards need to be able to say, 'Here is [our] appropriate scope of oversight, and here's what governance should do and not do.' Boards need to have rigor about what their job is. Then the board needs to ask management: 'What are we trying to maximize and how do we know we are doing what we say we are doing?' Once that list [of what is to be maximized] is made, the board needs to hold management accountable [for] those goals—it could be margin, community benefit, whatever—and decide on the rewards for those who succeed at reaching the goals." For health care and other nonprofit boards, there is one consideration they must always keep at the top of their list.

"At the end of the day, the question (for hospital boards) is, 'Who are we there to serve?'" Raber says. "That is a challenge that the corporate arena doesn't have."

For nonprofits, the answer comes through the mission statement. "Mission drives consensus in the nonprofit world, not only in answering 'What are we here for?' but also, 'How are we going to get there?'" Raber says. It is a question trustees must answer for themselves, he believes. "Management can make recom-

mendations, but board members need to bring in their [own] expertise," Raber says. "This will only happen if trustees bring strategic assets to the board, [the ability] to make things happen, not just say it."

However, Singleton thinks the board needs more strategic guidance from management as opposed to the other way around.

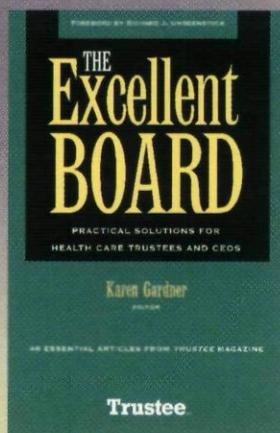
"Too many boards see the CEO as the administrator of the board's plans rather than the lead partner in strategy," he says. "Management needs to be the one to take on the tough issues. Boards need to force management to take the leadership role it should be taking—without that, a vacuum begins to form."

Ultimately, all boards must demand a "transparent tone from the top," Raber says, asking for all the information management has, from what's happening with that particular industry to what constituencies want—in other words, the "real scoop" about the organization.

Singleton advises nonprofit boards to learn three lessons from the corporate model: look at what they do best and follow those practices; hold management accountable to develop strategy; and finally, not to just "let things roll," but to actively govern. And that means they have to continually ask questions.

"Is the board passive or isolated? Does the board have active discussion? It's easy to find out the culture," Raber says. "A polite board is not a good board." **T**

LAURIE LARSON is Trustee's associate editor.



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