Rule Requires Board Members to be Expert Investors

Is your board ready to meet these new standards?

BY PERCY E. BOLTON AND ARTHUR V. BOLTON

Nonprofit boards, watch out. The fiduciary cop is back on the beat, arresting all offenders. A document called the "Third Restatement of Trusts," published by the American Law Institute, has been revised to reflect contemporary legal practice and investment theory.[1]

In its revised state, the Restatement specifies that nonprofit board members are fiduciaries and must comply with a high standard of conduct. This standard of fiduciary conduct establishes the "prudent expert rule". According to this rule, boards are to act and perform their investment responsibilities in an expert capacity.

The prudent expert rule assumes that the board has the knowledge and ability of an investment professional. Such standards impose a strict obligation on boards to fully understand the Restatement.

Under the prudent expert rule, board members are expected to maximize economic return and minimize risk. Achieving these countervailing goals is imposing for even the most capable investment expert in the best of economic circumstances.

Compounding these investment concerns is the issue of social responsibility. Nonprofits are expected to invest to make money but not in a way that will damage society.[2] Since most nonprofits are organized to achieve certain social and moral interests, boards should not invest in anything that jeopardizes those interests. It would be a delicate situation for the American Cancer Society's board to invest in a tobacco company, for example, no matter how profitable the anticipated returns.

Although the Restatement has been adopted in only a few states, uniformity is fast approaching. You can expect that every state will have legislated the Restatement into law within the next few years.[3]

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EIGHT WAYS TO PROTECT YOUR BOARD

This move to impose more stringent standards comes none too soon. As Don Trone of Callan Associates predicted in the September 1991 issue of Financial World, "Lawsuits against fiduciaries will be to the nineties what medical malpractice lawsuits were to the eighties". Unfortunately, his prediction has already come true. In this age of accountability, all fiduciaries are being scrutinized. Lawsuits have exploded, and fiduciary law is one of the fastest growing areas of specialized law.

Boards have been slow to respond to this changing landscape. Even most boards that have instituted change haven't done enough to absolve direc-

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tors. Their procedures still do not comply with the Restatement. For this oversight, most boards will be severely penalized in the years ahead. They are risking lawsuits against themselves and their organization, and they are even putting their organization's tax-exempt status in jeopardy.

Don't let this happen to you. To guide and protect your own board, establish the following procedures:

1. **Document all decisions in writing.**

   The board should keep minutes of all meetings and record all decisions, thus creating a paper trail. Board service is finite, and successor boards challenge many past decisions. What seems a good decision today may be interpreted as a bad one tomorrow. Leave no doubt, write it down.

2. **Establish and adopt clear investment policies.**

   The board needs to develop a written investment statement. This statement should outline the board's asset allocation policies, vendor and manager selection process, and guidelines for monitoring investment performance. Such a statement is crucial, for it establishes the due diligence process the board will follow in fulfilling its responsibilities.

   Be sure to review these investment policies periodically. Goals, society, people, and the economy are constantly changing. Therefore, it's important to assure that the policies reflect present conditions.

3. **Pay close attention to investment management.**

   Many boards treat the investment function as a stepchild, responding to it only when there's a problem. Educate both board and staff about investments and the investment process.

   Create a board investment committee, and select a committee chair who has sound judgment. The investment committee chair should be objective and have knowledge of investment management and policies.

4. **Hire all providers and professionals based on merit.**

   Boards should use prudent experts to assist them. Insurance companies, banks, and registered investment firms are considered prudent experts. Stockbrokers are not considered prudent experts. Prepare and use a request for proposal to assist in selecting the finalist.

5. **Hire an investment manager.**

   Don't have a board member act as the investment manager. Such a situation can lead to charges of self-dealing and conflicts of interest. Also, if a board member is selecting securities and managing the portfolio, the board continues to be liable. To transfer liability for securities selection, the board must give investment discretion to a professional money manager. Be sure to hire a money management firm that is properly bonded. If necessary, use consulting assistance in choosing the appropriate manager for the fund.

   If you cannot avoid having a board member manage the fund, be sure to hold that person to the same standards that would be required of outside counsel. Have all vendors sign the investment polity statement and acknowledge their co-fiduciary status in writing.

6. **Diversify your fund to reduce risk.**

   Research shows that diversification, if properly handled, not only reduces risk but enhances investment performance. Thus the board should strive to choose a mix of asset classes (stocks, bonds, cash, etc.) in creating its portfolio. The board can further diversify by using several money management firms whose styles are complementary. The board's responsibility is to assemble and direct a team of experts, not manage the portfolio.

7. **Monitor the performance of investment managers.**

   When you create your investment policy statement, you should include details of what you expect from your investments. Use these benchmarks to evaluate your investments' performance, and perform these assessments frequently. Don't accept the word of the money managers you hire. (That's like asking the fox to guard the hen house and to give an accurate account of the hens.)

Because of their carelessness, most boards will be severely penalized in the years ahead.

What seems a good decision today may be interpreted as a bad one tomorrow.

Instead, have a third party assess performance based on the benchmarks you have established.

8. Use social and moral screens to ensure that investments do not create social injury.

Nonprofits are under increasing pressure to become more socially responsible. Since they operate for the public benefit, nonprofits must ensure by their actions that public trust and high moral and social standards are retained. The newspapers are full of cases in which this trust has been violated, and the consequences have been extreme, including the loss of tax-exemption status. The board must impose criteria which will allow it to invest according to the organization's values, while simultaneously achieving a reasonable economic return. The values of the nonprofit should be reflected in its investment decisions.

ARE YOU MEETING THE STANDARDS?

If your board adheres to these eight principles, it will meet the high standards put forth by the revised Restatement. It's important to remember that the courts are more concerned that boards follow the correct process than they are with investment performance. Establishing the procedures in this article will protect your organization's tax-exempt status. It will also ensure that your board members fulfill the legal and social requirements in their role as fiduciaries. ■

Footnotes

[1]The "Third Restatement of Trusts" is available from the American Law Institute, 4025 Chestnut, Philadelphia, Pennsylvania 19103 (phone 215-243-1600).

[2]See "Is Your Principal Supporting Your Principles?" by Ron Freund in Nonprofit World, January-February 1987.

[3]For more on state liability laws, see State Liability Laws for Charitable Organizations and Volunteers, available from the Nonprofit Risk Management Center, 1001 Connecticut Avenue, N.W., Suite 900, Washington, D.C. 20036 (phone 202-785-3891).

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These publications are available through The Society For Nonprofit Organizations' Resource Center. For more information, see the Resource Center Catalog or contact the Society at 6314 Odana Road, Suite 1, Madison, Wisconsin 53719 (800-424-7367).

Solution to the Nonprofit Crossword Puzzle

(from November-December 1995 issue)

1 E	N	D	2 O	W	3 M	E	N	4 T	S	■	5 T	6 Q	M
F	■	■	P	■	I	■	■	H	■	7 D	■	U	■
8 T	9 O	K	E	N	S	■	10 F	A	S	B	■	11 I	12 N
■	K	■	N	■	13 S	C	A	N	■	■	14 A	D	A
15 A	■	16 C	■	17 M	I	■	18 A	K	19 A	■	■	20 P	E
21 C	A	U	T	I	O	22 N	■	23 Y	I	24 N	■	25 R	I
T	■	B	■	■	26 N	A	T	O	■	C	■	27 O	R
28 I	29 M	A	30 G	31 E	■	■	■	32 U	B	I	■	Q	■
33 O	A	■	34 A	P	35 I	■	36 P	■	■	B	■	37 U	38 S
N	■	■	L	■	39 S	H	A	R	40 E	■	41 V	O	A
■	42 P	E	E	R	■	■	S	■	43 S	F	A	S	■