

# LAW MEMO

## Lessons from the Kauffman Foundation Nixon offers suggestions, not sanctions

Months of turmoil at the Kansas City-based Ewing Marion Kauffman Foundation may be coming to an end thanks to a report issued on Mar. 4 by Missouri Attorney General Jay Nixon.

Nixon's 24-page report was prepared in response to allegations that, under the leadership of its new CEO Carl J. Schramm, the foundation was not following the intent of its founder, the late Ewing Kauffman. Also at issue were charges of inadequate board oversight and conflicts of interest. While Nixon found no specific legal violations, he made a series of recommendations that would solidify the foundation's commitment to Kansas City and tighten board control.

This issue of *Art Law Memo* summarizes the attorney general's report and suggests how his recommendations are applicable to nonprofit arts organizations.

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"With policies and procedures that are specific and faithful to Mr. Kauffman's vision, the foundation will continue to benefit the citizens of Kansas City — particularly the young people he cared for so much."

— Attorney General Jay Nixon

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### BACKGROUND

Pharmaceutical manufacturer, founder of the Kansas City Royals, and self-made billionaire Ewing Marion Kauffman established his foundation in 1966. He was active in directing the foundation's work until his death in 1993.

The Kauffman Foundation's assets are now worth in excess of \$1.6 billion, making it the largest foundation in Missouri (in terms of assets) and is among the 25 largest foundations in the nation. It is known for supporting entrepreneurship and youth development programs.

The Ewing Marion Kauffman Foundation is housed in a \$30 million facility that includes a 40,000-square-foot conference center. According to *Forbes* magazine, before Carl J. Schramm became CEO in 2002, the foundation had one of the highest overheads of any large foundation — 27 cents of every dollar.

Schramm, an entrepreneur with a doctorate in economics and a law degree, immediately made a slew of bold and often controversial changes ranging from disbanding two advisory boards to instituting a \$9.5 million voluntary employee buyout plan. The plan reduced the foundation's workforce by 41 percent to 95 employees.

There also were concerns about Schramm's new direction in grantmaking, which included a shift away from community development initiatives.

Changes made by Schramm prompted four trustees, including the board chair, to resign. In September 2003, an attempt to fire Schramm failed by a vote of 4 to 3.

Later that month, Missouri Attorney General Jay Nixon announced that he would investigate the foundation's management practices. His office, pursuant to Chapter 355 of the Revised Statutes of Missouri and the state's common law, represents the public in matters pertaining to nonprofit entities, including foundations.

Nixon's report addressed six areas:

#### 1. PURPOSES OF THE FOUNDATION

To determine the purpose of the foundation, Nixon first examined the corporation's Articles of Incorporation. Articles are filed with the Missouri Secretary of State when nonprofit corporations are established.

According to Nixon, the foundation's Articles "fail to articulate in any meaningful way the actual purposes of the corporation." Instead, the Articles contain a very broad statement that is necessary to acquire tax-exempt status from the Internal

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This issue was written by VLAA Executive Director Sue Greenberg.

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“Our review of Mr. Kauffman’s actions while serving the foundation, the many statements made by Mr. Kauffman and writings about him, and the actions of the foundation both before and after Mr. Kauffman’s death, confirm that Mr. Kauffman did not intend the foundation’s purposes to be as vacuous as the Articles suggest,” Nixon said.

He said the board should amend the Articles to “state clearly that the foundation’s purposes are, and always have been, to make a significant and lasting contribution to promoting self-sufficient people in healthy communities through youth development and entrepreneurial leadership.”

In addition, Nixon encouraged the board to provide a clear statement of intent as to whether the foundation’s widely disseminated strategic plans continue to reflect its current focus and direction.

Lesson: *Articles and mission statements should be drafted to provide flexibility without being overly broad.*

## 2. COMMITMENT TO K.C.

Although more than two thirds of the foundation’s grantmaking dollars went to Kansas City initiatives in 2003, there was speculation that the foundation was planning on increasing its national scope at the expense of local nonprofits, and that the headquarters might be relocated.

Nixon suggested that the foundation’s organizational documents be amended to reflect Mr. Kauffman’s clear commitment to Kansas City. The amendments should provide for “a substantial portion of programmatic expenditures” and a specific, substantial number of directors with “significant ties” to Kansas City, he said.

According to Nixon, another amendment should provide that the foundation’s headquarters will not be moved out of Kansas City without the unanimous vote of the board following a meeting soliciting public comment.

Lesson: *Nonprofit arts organizations should spend funds in*

*accordance with donor intentions.*

## 3. CONFLICT OF INTEREST

The most serious allegation against the foundation involved conflicts of interest. In particular, former board member Brian O’Connell was accused of exchanging his vote of confidence in Schramm for the promise of a lucrative consulting contract.

Ironically, O’Connell was the founding president of Independent Sector, a national coalition of voluntary organizations, foundations, and corporations, which seeks to preserve and enhance the American traditions of giving, volunteering, and nonprofit initiative, and is the author of several books, including the recently reissued *The Board Member's Book*.

Nixon determined that there were no legal violations regarding conflict of interest, but he criticized the board for being lax in its disclosure procedures. He called for the board to strengthen its conflict of interest policy and said it should train members regarding its provisions.

Lesson: *Perception can be very damaging. Nonprofits should have a conflict of interest policy for both the staff and the governing body. The policy should address all instances where an organization’s business or policy decisions can result in direct or indirect financial benefit to a member of the board or staff by setting out specific procedures to address actual, potential or perceived conflicts.* (See sidebar)

## 4. CEO’S RESIDENCE

Schramm commutes to work from Baltimore. During the search process, as determined by Nixon, the board expected that the new CEO would move to Kansas City. But the expectation was not incorporated into Schramm’s employment contract, although the contract did call for, and the foundation has paid, relocation expenses.

Nixon recommended that the board should require the foundation’s CEO to reside in the Kansas City area, and that the board should get a “definitive statement” of intention to relocate from Schramm.

Lesson: *The importance of*

*symbolism cannot be underestimated. Lesson: Employment contracts are a fairly common practice at major cultural institutions or when organizations replace founders. Generally, contracts clarify responsibilities and expectations, describe the compensation package, and contain termination provisions. They should be drafted with care.*

*Letters of appointment often are used for “at-will” employees. They, too, should be crafted with care.*

## 5. BOARD SIZE AND SELECTION

During the last few years, the size of Kauffman’s board has shifted from 13 members to four members. Nixon recommended that the foundation’s by-laws be amended to provide for a specific number of board members and procedures to fill vacancies. Those procedures, he said, should limit the role of executive management in the process and make some provision for community input.

Lesson: *By-laws should be reviewed periodically to make sure that they comply with state statute and that their procedures are being followed. If not, they should be amended or your organization’s practices should be changed.*

## 6. BOARD OVERSIGHT

Nixon determined that the Kauffman Foundation board of directors “has over time formally and informally divested itself of many of its control and oversight opportunities.”

For example, Nixon found that very few individual grantmaking decisions, which he called the most critical of all the foundation’s decisions, are acted on by the board. He reported that the authority to reject or award nearly all grants has been “delegated down.” The CEO also has authority to enter into service contracts that are under \$500,000.

Nixon acknowledged that certain delegations are necessary and appropriate. But “when the delegation is of this magnitude,” the attorney general said, “it creates a situation ripe for abuse by management.”

In addition, the board never

formally authorized Schramm's workforce reduction plan. Nor did it approve his plan to dismantle the two advisory boards.

Nixon found no evidence that these shortcomings were the result of bad faith, lack of interest or mismanagement. But he said the board needs to "re-assess and formalize its oversight and control of the organization at every level."

Lesson: *The relationship between the board and the chief executive plays a pivotal role in an organization's success. The board can, and should, delegate day-to-day administrative matters to the chief executive. At the same time, it must provide oversight and participate in key decisions.*

*In addition, the board should not give too much authority to the board chair or executive committee. While the executive committee is empowered, within limits, to act for the full board between meetings, it should avoid taking extraordinary or drastic action, setting policy only in an emergency.*

*Likewise, the full board should not abdicate its fiduciary responsibility by simply rubber-stamping the recommendations of the chair or the executive committee.*

## 7. COMMUNITY ACCESS

While private foundations are not required to provide direct public access or input into their operations, the attorney general said the board should explore ways to keep the Kansas City community involved in its work.

More specifically, Nixon asked the board to "weigh carefully the benefits and costs of its historical practice of organizing community forums to address emerging issues, and make a definitive and public statement about the extent to which it will continue to fulfill this critical community function."

Lesson: *Be accessible and responsive to members of the public and the media who express interest in the affairs of the organization.*

Lesson: *Do not eliminate popular programs without stakeholder involvement in the decision and a public relations strategy.*

## Conflict of Interest Policies

Legally, nonprofit board members have two duties: the duty of care, which requires them to act as an ordinarily prudent person would under similar circumstances; and the duty of loyalty, which requires board members to act for the benefit of the corporation rather than for personal gain. The duty of loyalty requires board members to be aware of potential conflicts of interest, disclose them with candor, and refrain from voting on the transaction.

To develop a conflict of interest policy, begin by answering these questions:

- What measures are needed to promote fairness and foster good will in our community?
- What is the appropriate form of disclosure for board members to make known their connections with those doing business with our organization?
- How will the board elicit this information in a manner that is sensitive to the personal privacy of those who are involved? Do we need a mechanism for annually updating the needed information?
- How are staff members with actual or potential conflicts involved in your organization's transactions? Your decision-making process?
- Should our procedures go beyond what is required by law?

### Sample Policy

*A possible conflict of interest exists when a director has a material personal interest, either direct or indirect, in a proposed transaction involving this organization. When a director has an interest in a transaction being considered by the board, the director should disclose that conflict before the board of directors takes action on the matter. Any board member having a conflict of interest will not vote or use his personal influence on the matter. The minutes of the meeting will reflect that a disclosure was made, and the abstention from voting.*

*This policy also will apply to immediate family members, the organization's committees and its volunteer association. Directors, committee members, and officers of the volunteer association will be required to attest annually to their familiarity with this policy, and to provide information concerning any possible conflict of interest so that disclosure, if necessary, is made.*

*Staff members and their immediate families will not benefit materially from the organization beyond receipt of salaries, fringe benefits, and reimbursement for authorized expenses.*

Source: VLAA's Guide to Board Duties and Liabilities

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## Resources

### BoardSource ([boardsource.org](http://boardsource.org))

Formerly the Center for Nonprofit Boards, BoardSource is considered the premier resource for building strong and effective boards. It publishes a variety of affordable booklets, and its web site features an array of governance information, including topic papers, summaries of essential knowledge for nonprofit boards, an extensive Q&A section, and useful links.

#### Books

Eadie, Douglas C. *Extraordinary Board Leadership: The Seven Keys to High-Impact Governance*

O'Connell, Brian. *The Board Member's Book: Making a Difference in Voluntary Organizations*

Robinson, Maureen K. *Nonprofit Boards That Work: The End of One-Size-Fits-All Governance*

Widmer, Candace and Houchin, Susan. *The Art of Trusteeship: The Nonprofit Board Member's Guide to Effective Governance*

These books and many others on arts law and business practices are available at the St. Louis Volunteer Lawyers and Accountants for the Arts library, located within the Regional Arts Commission office, 6128 Delmar.