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**KEEPING NONPROFIT
GOVERNANCE IN PERSPECTIVE**

I. Introduction – Overview of Nonprofit Governance

- Why us, why now? Nonprofits are being scrutinized as never before.
 - They are newsworthy – television shows are discussing overcharges and aggressive collection techniques.
 - Some perceive hospitals as greedy and unresponsive. Yet sick people provide constant demand while health care costs threaten all of us.
 - President Bush recently told the American Hospital Association (“AHA”) that Hospitals need to “make information on prices and quality available to all your patients.”
 - The recent conviction of Enron executives.

The conviction of some Enron executives hardly brings closure to the current era in which nonprofit corporations, as well as for-profit companies, are expected to perform at much higher levels of visibility, including greater accountability, transparency and tightened governance. The Enron executives will no doubt appeal their convictions, and even an ultimate sentencing will do little to protect Enron’s former employees or investors. It is generally conceded, however, that the Enron debacle prompted Congress’s strong immediate response, the enactment of the Sarbannes–Oxley Act of 2002 (“SOX”). Conceived as essential for investor protection, SOX requires better control of publicly traded for-profit companies and their operations, including internal audits and routine testing by management in key areas of operation. Executives (primarily the CEO and CFO) are expected to personally certify the accuracy of financial statements.

While the majority of SOX was welcomed in the board rooms of large publically traded companies, smaller publicly traded entities and nonprofit organizations were concerned about the time and cost of compliance. To keep nonprofit governance in perspective, it is important to have a sense of proportionality and to adopt “best

practices” that serve the organization’s specific purpose. Well crafted policies that are not applied will actually be counterproductive.

This article attempts to outline the best practice guidelines developed from SOX and commentators on nonprofits. However, these developments were already occurring without federal requirements. In fact, many of the suggested “best practices” are not legal mandates, but suggestions that nonprofit organizations should specifically review in light of their own risk assessments. Nonprofit organizations should adopt the versions and provisions best suited to their specific business type and scope of operations.

II. SOX Implications for Nonprofits

- Sarbannes-Oxley Act of 2002 (“SOX”)
 - Fundamentally changed securities laws
 - No change to 10(b)(5) fraud rules
 - Nonprofit application of SOX is extremely limited
 - Sets up checks and balances between public companies and their:
 - Officers
 - Shareholders
 - Directors
 - Consulting, Accounting and Legal Professionals
- The governance aspect of SOX:
 - Applies in two areas for nonprofits: whistleblower protection and document retention
 - Defines independent directors
 - Imposes new obligations and regulations on audit committees
 - Bans most loans to officers and directors
 - Establishes minimum standards for lawyers
 - Requires director independence only for audit committee, but overall independence is big with the IRS, consumer watchdog groups, and others
- More effective oversight

- Transparency (requires disclosure of more information to public and regulators)
 - Performance Data
 - Executive Compensation (990 disclosures)
 - Board structure, size and composition
 - Audit Committee (independent, disinterested)
 - Conflicts of interest (nonprofits must address and effectively deal with these)

III. Nonprofits Should Adopt Best Practices

- Rating Agency(ies) want(s) “best practices.” Fitch/Moody’s as well as Insurers
- Attorneys General – Scrutiny is intensifying
- Class Actions re “charity exemptions” vs. billing practices
- Fear of litigation, competition and more regulations
- New focus from Congress (more intense than past)
- Need to define terms and measure performance – *e.g.* community benefit
- Improve poor communication (not just one annual report to community). You need a full range and enhanced budget for media, webpage, monthly and quarterly reports with more meaningful data, *e.g.* outcomes
- Federal Sentencing Guidelines suggest annual risk assessment – This obviously requires more time/money = bigger workload Nonprofits should develop their own database in summary reports:
 - Risk areas
 - Action plans
 - Charts
 - Assure direct access of Corporate Compliance Officer to Board and CEO
 - Staff and board education

IV. Building a Culture so that SOX Works to Your Advantage

- Be proactive:

- Allow time for meaningful Q & A of management and the Committee
- Do not create a negative culture - *e.g.* focusing only on financials
- Board oversight is directly tied to fiduciary duties
- Disney and Caremark cases – no “sleeping at the switch.”
- Avoid perfunctory reports – glossing over
- Seek advice from other organizations (especially those similar in size/scope)
- Welcome internal audits/self-identification of non-compliance; *see* The Unexpected Benefits of Sarbannes-Oxley, Harvard Business Review April 2006 www.hbr.org

V. **Recipe for Governance Disaster in Nonprofits**

- Thinking one size fits all or using checklists without focusing (having too high aspirations can't hurt you)
- Resisting, as too expensive, even simple SOX regs – *e.g.* 404 Certifications by CEO and CFO
- Assuming SOX doesn't apply to NFPs, so ignoring other implications:
 - Local tax exemption revocations
 - State laws
 - Senate Finance Committee
 - IRS – executive compensation / private inurement
 - Bad press
 - Class actions
 - Higher capital costs or even failure to get financing
- Considering internal audits wasteful – relying on external public relations
- Treating conflicts as inevitable and routine, *e.g.*, no ongoing disclosure
- Seeking collegiality over independence in Board composition – skipping Board self-evaluation
- Blending for-profit activities and operations into nonprofit structures and activities

- Accepting all “interested” candidates for Board – no recruitment/Retention policies
- Discouraging communication between General Counsel and Board, between Compliance Officer and General Counsel, and between Board and Management
- Not bothering to review bylaws and documenting compliance in minutes
- Keeping to tight time limit / 1½ hour Board meetings – discouraging questions; delegating fully to Committees
- Sticking to substance, not process – avoiding new Board orientation or review of Board and Committee charter/structure/function

VI. Transparency

- CMS plans to publish amounts paid to hospitals and outcomes
- State and AHA are making efforts to measure community benefits; they are producing reports on charity care and bad debt as part of community benefits
- Expect more requirements for outcomes/mortality
- Upcoming legislation requires paying for uninsured as part of consideration for charitable exemptions
- Accountability is a two way street; Providers, patients and payers all need higher standards

VII. Conclusion: The best defense is a good offense

- Recognize the problem using self-assessment tools
- Enhance the Corporate Compliance Program
 - Governance should be tightened in:
 - Policy
 - Documents (review Articles and Bylaws to include SOX and governance provisions)
 - Process
 - Fact
 - Careful Tax Compliance
 - Strengthen/tighten Conflict of Interest policies/processed - ongoing

- Executive Compensation/Audit Committee – need Independence
- Strengthen internal controls – probably demanded by lenders and regulators, but not every matter; exclude minor items
- See MHA’s Best Practices in Hospital and Health System Governance (Nov. 2005) www.mhanet.com
- Strengthen the Board Committees and their ability to exercise true oversight (perhaps with outside assistance)
- Be patient in assessing all complaints and deal effectively with valid problems
- Need major communication upgrade (accountability and transparency)
- Need proactive input with Congress and state legislatures as well as others to keep all this in perspective
- Keep sense of welcoming those “best practices” that fit and tailor to your organization.

Nonprofit organizations face many challenges. Most welcome the opportunity to improve their performance and to realize operational and strategic advantages. It is important for nonprofits to address best practices, whether legally mandated or otherwise. It impacts their ability to raise funds, to retain tax-exempt status from the IRS and others, to recruit and retain Board and committee members, and to achieve and enhance fulfillment of their charitable missions. By keeping nonprofit governance in perspective, nonprofit organizations should be able to implement properly focused policies and procedures. Such implementation will be a key to their success.

(For further Information regarding SOX compliance, please contact

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