



Coalition for
Nonprofit
Health Care

Corporate Responsibility Guidebook

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Introduction

This Guidebook provides advice to members of the Coalition for Nonprofit Health Care (“CNHC” or the “Coalition”) and other nonprofit organizations who are developing an appropriate response to the current “corporate responsibility” environment and recognizing the unique challenges presented thereby. By following this advice, CNHC members and other forward-thinking health care providers can demonstrate leadership in the nonprofit sector and encourage others to follow their “best practices.” However, the advice below may need to be tailored to the size and complexity of a particular organization.

This Guidebook is based upon the following fundamental premises:

- *First*, the wave of Wall Street accounting scandals and related corporate responsibility legislative and regulatory initiatives is relevant to nonprofit organizations, notwithstanding the fact that many, if not most, strive to be at the forefront of accountability.
- *Second*, nonprofit organizations can learn important lessons from corporate accountability controversies that suggest specific responsive actions by those organizations, their managers, and their governing bodies.
- *Third*, the core standards of fiduciary duty have not been changed by these controversies, though the expectation of what may constitute “reasonable and prudent action” by an officer or director now may be heightened.
- *Fourth*, while the newly-emerging corporate responsibility environment does not mandate an adversarial relationship between governance and management, neither does it tolerate a less-than-arm’s-length relationship. It is crucial that these two constituencies reach a basic understanding on the appropriate organizational response(s) to corporate responsibility issues.

To help Coalition members and other nonprofit health care organizations apply these fundamental premises and devise appropriate responses to the current environment, this Guidebook is divided into three separate segments:

- Part I.** An overview and background of the corporate responsibility environment.
- Part II.** A discussion of the potential effect of corporate responsibility on the governance/senior management relationship.
- Part III.** A list of specific corporate responsibility-related action items recommended for nonprofit healthcare organizations, which includes consideration and possible adoption of new governance policies and relevant portions of the Sarbanes-Oxley Act.



Part I: The Corporate Responsibility Environment

The concept of corporate responsibility arises not from a single event or legislative initiative, but rather from a series of recent corporate financial and accounting investigations and public officials' related responses. Notably, these scandals include AHERF, Allina, and Enron. Collectively, these investigations served to create an environment in which extraordinary focus is being placed upon the ability of corporate governance and management to conduct business or charitable affairs in a manner that preserves the fiscal integrity of the corporation for the benefit of its shareholders (or, with respect to nonprofits, for the beneficiaries of the corporation's charitable trust or mission).

A. Allina and AHERF

In one sense, the beginning of the corporate responsibility environment as applied to nonprofit health care can be traced to the 2000-2001 business review investigation of Allina by the Minnesota Attorney General. The headlines surrounding Allina encouraged attorneys general to more closely monitor governing boards of charitable organizations. In this case, the essence of the Attorney General's allegations was that Allina governance had failed to exercise sufficient oversight over corporate affairs so that members of senior management were able to pursue business practices (*e.g.*, alleged waste of corporate assets) that were inconsistent with the charitable mission of the system. The Minnesota Attorney General's investigation was very public and involved allegations about the misuse of funds **that never were substantiated or confirmed**. Well-founded or not, however, the Attorney General's review resulted in the execution of a ground-breaking settlement agreement with Allina that mandated a substantial restructuring of governance policies and management staffing, and divestiture of its HMO affiliate.

Another important catalyst was the long-running saga of the bankruptcy and related litigation involving AHERF, which began in 1998. At its core, this controversy involved alleged failures of oversight by corporate governance and lapses in the monitoring of the financial integrity of the health system and the actions of certain members of senior management. The bankruptcy, and ultimate settlement of ongoing litigation in 2002, resulted in the return of over \$75 million to existing endowment funds. These payments were contributed by four insurance companies and Mellon Bank. The high-profile AHERF failure (and resulting dissipation of charitable assets) has made state attorneys general increasingly sensitive to their obligation to monitor the degree of stewardship of charitable assets by governing boards.

B. Enron

Outside of the charitable organization context, the most visible and notorious cause of the corporate responsibility environment to date has been the financial collapse of Enron Corporation. When it declared bankruptcy on December 2, 2001, Enron was the seventh largest company in the United States, with over \$100 billion in gross revenues and more than 20,000 employees worldwide.

The bankruptcy filing resulted in the loss of thousands of jobs and billions of dollars in equity and prompted investigations by Congress, the Securities and Exchange Commission, and the Department of Justice. Enron's collapse also led to the filing of multiple shareholder lawsuits alleging breach of fiduciary duty, among other claims. Just as Studebaker's failure in the 1960s led to fundamental overhaul of American pension policy a few years later, Enron's collapse prompted the current atmosphere of intense scrutiny of corporate financial and accounting operations. It already has led to investigations of many major U.S. corporations and enactment of new federal legislation addressing a wide variety of corporate responsibility initiatives. At this still early stage, it is not possible to predict how far these changes may take business and financial accountability policy.

Enron's financial collapse was caused in large part by financial restatements related to complex "related party" and "off balance sheet" financial transactions. These were pursued in order to achieve certain financial statement objectives, necessitated by the economic fluctuations of Enron's business. Enron is somewhat unique because of the complexity of the underlying allegations, *e.g.*, deception by using corporate transactions to move assets off financial statements and to improperly inflate earnings. "The allegations at WorldCom and Adelphia are addition and subtraction. Enron is calculus." (*The New York Times*, p. A-7, 8/22/02.)

The Enron bankruptcy, at least, prompted several high profile examinations of the conduct of Enron's Board of Directors during the timeframe in which the suspect transactions occurred. These examinations served in large part as the basis for the subsequent enactment of the federal Sarbanes-Oxley Act (see below).

The initial examination was conducted by the Special Investigative Committee of the Board of Directors of Enron Corporation.¹ Its Report (prepared with the assistance of special counsel) contained a detailed self-analysis of the governance actions related to the entire accounting controversy, and reached several important conclusions, including the following:

- Board and management oversight were impaired by conflicts of interest;
- The concept of the related party transactions was flawed;

¹ Dated February 2, 2002. This is the so-called "Powers Report," as the Committee was chaired by Dean Powers of the University of Texas Law School (and a member of the Enron Board).

- Board-adopted controls were inadequate and not appropriately implemented;
- Senior management did not exercise sufficient oversight;
- Senior management did not respond adequately when issues arose that required a vigorous response;
- The Audit and Compliance Committee of the Board carried out its assigned review in a cursory manner;
- The Board was denied important information that might have led it to take action;
- The Board did not appreciate fully the significance of some of the specific information that came before it; and
- The outside auditors did not identify or bring to the Audit Committee’s attention the inadequacies in Enron’s internal controls.

A subsequent examination of Enron was conducted by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, U.S. Senate.² The Subcommittee conducted an extensive examination of the Enron matters, reviewed over one million pages of subpoenaed documents, interviewed thirteen Enron Board members, and received testimony from several governance experts. The Subcommittee’s conclusions were that:

- The Board failed to safeguard corporate assets and contributed to the corporation’s collapse by allowing it to engage in: (1) high risk accounting practices, (2) inappropriate conflict of interest transactions, (3) extensive off-the-books activities, and (4) excessive compensation; and
- The independence of the Enron Board was compromised by financial ties between the company and certain Board members.

The Subcommittee also made several recommendations with respect to how (publicly traded) companies conduct their business affairs. The first recommendation related to the need to strengthen the financial oversight of corporate affairs, while the second related to the need to strengthen the independence of corporate governance. Both were reflected in the final version of the Sarbanes-Oxley Act.

C. Sarbanes-Oxley Act

On July 30, 2002, President Bush signed into law new corporate oversight legislation (the “Sarbanes-Oxley Act”). The new law was conceived as a set of legal reforms in response to: (a) the corporate accounting controversies of 2002, (b) the need to protect the interests of investors, and (c) the need to provide stability to financial markets. The Act establishes a new

² Dated July 8, 2002, entitled “The Role of the Board of Directors in Enron’s Collapse.”

oversight mechanism for the public accounting profession, creates new rules for the auditor/client relationship, and institutes new criminal penalties for corporate finance-related crimes. It also establishes corporate responsibility procedures for executive and board conduct, assigns new ethical obligations to corporate counsel, and provides new protections for investors. The Act applies only to publicly-traded companies.

On June 6, 2002, the Corporate Accountability and Listing Standards Committee of the New York Stock Exchange (the “NYSE”) issued a detailed set of corporate governance recommendations designed to enhance the accountability, integrity, and transparency of the NYSE’s listed companies. Among the most significant recommendations are those related to: (a) increasing the role and authority of independent directors, (b) adding new audit committee qualification requirements, and (c) establishing new corporate control and internal enforcement mechanisms.

D. Recent Developments Regarding Charitable and Tax-Exempt Organizations

A series of other recent developments help define the current corporate responsibility environment. These developments include the following:

- Two ongoing shareholder derivative actions involving prominent health care companies (HCA/Columbia and Abbott Labs) that seek to hold corporate directors liable for their alleged failure to act in the face of “red flags.” In these actions, the key legal allegation is that the directors are not entitled to indemnity protection because of the egregious nature of their conduct (*e.g.*, ignoring danger signs).
- A suit by the Art Institute of Chicago (“AIC”), a nonprofit corporation, against a Dallas hedge fund in which it lost at least \$23 million (and perhaps as much as \$43 million) in 2001. The AIC also dismissed its long-time investment advisor.
- A Congressional and federal investigation of a Washington, D.C., affiliate of the United Way concerning allegations that it had been misappropriating money and deliberately withholding information its Board needed to conduct oversight activities.
- An April 2002 report by the U.S. General Accounting Office (“GAO”) on tax-exempt organizations (including hospitals) that expresses concerns about the appropriate balance between fundraising activity and general management, on the one hand, and program services, on the other hand. The GAO’s report recommended a series of improvements in public, Internal Revenue Service, and state oversight of charities.
- A September 4, 2002 Announcement of the IRS that it seeks comments on proposed changes to Form 990 (Return for Organization Exempt from Income Tax) to address

corporate responsibility concepts. The IRS Announcement acknowledges the policy benefits of confirming the veracity of information disclosed by charitable organizations.

Finally, the National Association of State Charity Law Officials, at its October 7, 2002, meeting, addressed a variety of corporate responsibility-related issues, including a study of how Enron and related accounting issues may affect charitable organizations in the future, and specific state initiatives on accountability by nonprofit organizations.

E. Summary

Collectively, the above events frame the new corporate responsibility environment in which all nonprofit health care organizations must operate. It is an environment in which governmental scrutiny of the oversight of the business and financial affairs of corporate America is at a near all-time high. The agencies with jurisdiction over nonprofit corporations—attorneys general, state charity law officials, the IRS, and, to a lesser degree, the Securities and Exchange Commission—readily recognize public policy (and political) reasons for extending application of corporate responsibility initiatives to such organizations. Thus, Coalition members and other nonprofit healthcare organizations would do well to evaluate their corporate governance structure and take any measures necessary to bring this structure in line with the pressures and expectations of the new environment.



Part II: Effect on the Governance/ Senior Management Relationship

As noted above, much of the review of the corporate accounting scandals and related concerns has been focused on the role of corporate governance and the extent to which governance properly fulfilled its oversight obligations with respect to business and financial affairs. Indeed, in many instances, directors of the subject companies have been severely criticized for alleged failure to properly oversee the activities of senior management. The Powers Report and the Senate Permanent Subcommittee Report are prime examples of situations where corporate directors have been admonished for failure to adhere to fiduciary obligations.

Accordingly, in the new corporate responsibility environment, it is natural to expect members of nonprofit health care governing boards to be more attentive to the proper fulfillment of their fiduciary obligations. The pendulum of power, which over the last decade swung steadily toward greater management discretion and less board involvement in decisions, is now swinging back toward more interaction and supervision. This likely will continue for some time. Nonprofit boards can be expected to be more sensitive to the proper role of corporate governance and to be responsive to the obvious lessons learned from Enron and its progeny. Understandably, this may affect the relationship between governance and management. In particular, more attention likely will be focused on some of the following:

1. Increased Focus on Oversight Obligations, Generally. Health care executives should expect their trustees or directors to be more vigorous in exercising their oversight obligations. Directors are not obligated to manage the day-to-day affairs of the company and may delegate that function to others, but must exercise reasonable and prudent oversight with respect to the corporate officers, agents, and employees to whom such affairs are delegated. Enron will be cited as a spectacular illustration of the consequences of a board's failure to exercise its oversight obligations. In this context, Senator Charles Grassley asked, ". . . [a]re the boards of these corporations doing their jobs? Boards should be looking out for the organization, whether it's a charity or a company, not for the managers of that organization." Nonprofit directors are likely to need [governance education](#) on the proper balance between the necessary delegation of business responsibilities to corporate executives and the degree of vigilance to be exercised by the board over senior management's exercise of those delegated responsibilities.

2. Specific Focus on Financial Matters. At the heart of the corporate responsibility concept is the obligation of the board to monitor the current business and financial performance of the corporation. From AHERF to Enron, a common thread is that the governing board failed to effectively monitor the financial affairs of the corporation and the integrity of its financial statements. Sarbanes-Oxley refocuses attention on the accuracy of financial statements and

disclosures (including the CEO certification requirement) and the sufficiency of internal accounting procedures and controls. Reported litigation involving the former management and auditors of Nyack Hospital (N.Y.) underscores the vulnerability of the board of a financially distressed hospital to allegations of lack of oversight. In Nyack, the hospital restated two years' worth of financial statements due to overstatements of accounts receivable and problems recording medical-related revenues and costs.³ Prudent directors will insist on being closely advised of the financial status of a corporation, especially if it approaches financial distress, as the scope of their potential liability increases materially in the "Zone of Insolvency."

3. Management's Obligation to Inform the Board. Senior management should expect boards to be more demanding with respect to reporting on financial and operational matters. A central allegation in Enron, for example, is that management failed to keep the board advised on important financial and accounting matters. Management has an affirmative obligation to keep the board informed on all material corporate matters in a timely, accurate, and understandable manner, and to identify the relative risks and rewards of individual corporate initiatives. A director is entitled to rely (absent knowledge that would render reliance unwarranted) on reports, opinions, information, and financial statements presented by corporate officers and directors. Sarbanes-Oxley suggests that nonprofit boards should strive to become better informed by management in matters relating to the integrity of the corporation's financial statements and its financial stability. As required in the Allina settlement, it may also be appropriate for the board to interact directly with and regularly seek (at board meetings and otherwise) the views of senior managers other than just the CEO.

4. Reliance on Experts. Enron focused attention on the extent to which a governing board may rely upon the advice of experts. The board has the right to rely on the advice of experts (*e.g.*, legal counsel, public accountants, and consultants) that board members reasonably believe to be within their professional or expert competence. The board should always have access to these experts and to their written reports and advice, including an evaluation of the risks and rewards of corporate transactions. In rendering material decisions, trustees or directors should be informed as to the related advice of the corporation's professional advisors.

5. The Sergeant Schultz Defense. A central theme in many corporate controversies is that the governing board was unaware of the circumstances that gave rise to the alleged problems, and thus should be insulated from personal liability for related decisions. This raises questions about the application of an "ignorance defense" (a/k/a the "Sergeant Schultz Defense"). Prior to *Enron*, establishing director liability for failure to monitor corporate affairs was traditionally one of the most difficult theories on which a plaintiff could hope to win a judgment. This may change, post Enron. A trustee or director is not required to exercise proactive vigilance to ferret out corporate wrongdoing, nor is he or she otherwise obligated to anticipate future problems of the corporation. The well-known "Duty to Inquire" exists only when suspicions are aroused or **should be aroused**; *i.e.*, when a director is presented with a proverbial red flag. In

3 See "Double Jeopardy," *Modern Healthcare* (July 29, 2002).

such cases, directors should make further inquiry until they are reasonably satisfied that management is dealing with the situation in an appropriate manner. The ultimate question for liability purposes is whether the director recognizes the red flags when they arise. The ignorance defense will not apply if the board failed to recognize a red flag when it was presented to them. Trustees or directors should henceforth be more inquisitive on matters requiring their attention and should, when necessary, request information be submitted to them in a more understandable format.

6. The Duty to Inquire. The Powers Report concluded that the Enron Board did not appreciate the significance of much of the information about proposed transactions with which it was presented. A fundamental precept of the fiduciary “Duty of Care” is that a director is obligated to render decisions on an informed basis. Post Enron, many boards will focus more attention on the manner in which they receive information from management in order to render prudent decisions. When in doubt, a director’s duty is to make appropriate inquiry of management or experts, and, in fulfilling this duty, he or she may request that the information be re-submitted in a format that provides greater clarity. If the director believes that the board has not been provided with a satisfactory level of information in a timely manner, he or she should request that the proposed action be delayed pending further clarification. Directors should also periodically make inquiry to satisfy themselves of the effectiveness of the corporate compliance plan and related initiatives.

7. Conflicts of Interest Concerns. Nothing will attract the interest of a regulator of charities more quickly than allegations of conflict of interest or self-dealing at the management or board levels. (Even though it is a for-profit company, substantial notoriety resulted from the Enron Board’s decision to waive its corporate ethics/conflicts policy to facilitate some of the “special interest” transactions.) While virtually all tax-exempt organizations maintain conflicts of interest policies and procedures satisfying basic IRS standards, it may be legitimate to question now whether they are adequate in scope and practice given emerging corporate responsibility standards. Such a review might include considering the following questions: (a) Does the policy clearly define the scope of a potential conflict (*e.g.*, does it include nonfinancial interests such as outside business activity and service on the board of a competitor)? (b) How detailed is the conflict of interest questionnaire? (c) Are directors aware that the “duty to disclose” is ongoing, rather than merely annual? (d) What procedures are established to monitor disclosures and to evaluate potential conflicts?

8. Executive Compensation Concerns. A very likely consequence of the current environment is that executive compensation arrangements will be subject to increased scrutiny.⁴ Corporate and tax law is clear that executives of charitable organizations can be paid at reasonable, fair-market value levels. However, there is increasing regulatory pressure on an organization’s ability to justify the reasonableness of executive compensation. The board is obligated to

4 For example, the Internal Revenue Service has underscored its interest in assuring the reasonableness of compensation arrangements with management and corporate “insiders” through the new Intermediate Sanctions regulations, as well as in position statements established in its Continuing Professional Education Textbook for fiscal year 2002.

ensure that executive compensation arrangements are reasonable in terms of amount and structure (*e.g.*, incentives closely tied to achievement of charitable mission) and that reasonableness is thoroughly documented in a manner consistent with law.

9. Attention to Investment Management. The magnitude of the AIC's hedge fund loss underscores the threat to a corporate endowment fund (and a corresponding liability threat to involved trustees or directors) for imprudent investment management practices. While the laws of most states (*e.g.*, Uniform Management of Institutional Funds Act, "UMIFA") provide broad latitude in making investment decisions, the board remains obligated to monitor fund performance and consistency of investment decisions with the financial needs of the organization. State charity officials are particularly sensitive to concerns of imprudent investment practices in periods of "down" securities markets. Nonprofit directors should interpret the recent investigations as offering valuable guidance on how regulators and other public and private stakeholders (including the media) react to certain types of alleged director misconduct and should refine their own conduct accordingly.

The greatest effect of the current corporate and accounting controversies will undoubtedly be felt in the corporate boardroom. Nonprofit health care governing boards are likely to recognize the lessons to be learned from Enron as well as from AHERF and Allina and to seek to implement appropriate adjustments to the manner in which they exercise oversight over financial matters.



Part III: Corporate Responsibility Initiatives for Nonprofits

Given the foreseeable extension to nonprofits of corporate responsibility initiatives generally, and the increased emphasis on fiduciary obligations in particular, senior management and governance of nonprofit health care organizations would do well to consider strategies they can implement now to respond to anticipated oversight concerns about governance. An obvious first step includes **strengthening governance education**. In addition, the relevance of corporate responsibility to charitable organizations, especially in nonprofit health care, begs for individual institutional responses to the policy concerns raised by current controversies. In that regard, two specific strategies may be worth considering as first line responses to the corporate responsibility environment—(1) adopting specific governance policies and (2) implementing selected Sarbanes-Oxley provisions.

1. Adopt Specific Governance Policies Now. A potentially effective tool to assist members of corporate governance in the exercise of their fiduciary duties is the **adoption by the board** of a series of policies designed to respond to the governance challenges created by Enron and its progeny. These policies should incorporate basic considerations of fiduciary law as well as reflect an awareness of the most controversial board actions (and inactions) alleged to have occurred in Enron and some of the other corporate scandals.

The most relevant (to corporate responsibility) policies that a board should consider adopting include the following:

a. Governance Policy. A *Governance Policy* is an overarching summary of an individual trustee's or director's core duties. Based on the *Bishop Estate* settlement,⁵ its purpose is to provide the framework within which directors will execute their fiduciary duties. As such, it should contain a clear statement of the corporate mission as well as an explanation of the directors' core duties of care, loyalty, and obedience to purpose.

b. Enhanced Conflicts of Interest Policy. An enhanced *Conflicts of Interest Policy* goes beyond the basic financial interests test of the IRS and extends coverage to (i) specific hospital/physician conflict or competition considerations, (ii) nonfinancial potential conflicts, (iii) dual directorships in general, and (iv) concurrent service on an affiliate, vendor, or competitor board in particular. This Conflicts of Interest Policy should contain a director questionnaire designed to solicit information regarding the foregoing areas of concern.

⁵ The Internal Revenue Service entered into a final closing agreement in Estate of Bernice Pauahi Bishop (a/k/a Kamehameha Schools Bishop Estate) on February 23, 2000, following release of a tentative settlement in late 1999 (BNA's Daily Tax Report, No. 236, G-8, 12/9/99).

c. Corporate Opportunity Policy. A policy on *Corporate Opportunity* establishes the basic prohibition against “usurping of corporate opportunity,” *i.e.*, where one manager or board member personally takes advantage of a business opportunity that the corporation would otherwise have pursued. This policy defines proper board action when an appropriation issue arises and provides guidance to the board on how best to identify system opportunities.

d. Confidentiality Policy. A straightforward and strongly worded policy on *Confidentiality* emphasizes a director’s fundamental duty to maintain the confidentiality of board actions as well as all other information regarding the corporation’s activities until they are disclosed to the public by the corporation or are otherwise in the public domain. The penalties for breach of this duty (*e.g.*, removal) should be set forth in the policy.

e. Outside Board Service Policy. An *Outside Board Service Policy* sets forth the board’s position on concurrent board service by directors and senior managers. While concurrent board service is not a breach of any duty, *per se*, it can raise issues related to conflicts of interest, compensation, full-time employment or board service, and mission conflicts, among others. An outside board service policy should contain a questionnaire designed to solicit relevant information.

f. Oversight Policy. An *Oversight of Senior Management Policy* defines this basic board obligation. To be effective, the policy must not undermine the board’s ability to delegate day-to-day operations to the senior management team, but it should clearly remind the board to be sensitive to potential management activity “red flags.” This policy should also address a director’s “duty to inquire.”

g. Board Compensation and Indemnification Policy. Most states allow director compensation and indemnification within nonprofit corporations. If a nonprofit corporation chooses to pay and/or indemnify its directors, it should create a specific policy on *Board Compensation and Indemnification*. This policy should include the rationale for compensation and indemnification, explain how directors are to be paid or indemnified, establish limitations on total compensation, and identify how compensation and indemnification decisions will be approved by a disinterested body.

h. Investment Management Policy. Given the importance of an investment portfolio return to many nonprofit hospitals and systems, an *Investment Management Policy* delineates the basic guidelines and premises the board should use to invest the organization’s assets through its investment committee and financial advisors. This policy should stipulate that investment practices be made in a manner consistent with governing law (*e.g.*, the UMIFA) and with a clear articulation of the organization’s investment needs. This policy should also include guidelines for the use/application/monitoring of restricted funds and the solicitation of charitable gifts.

i. Corporate Audit Policy. A policy that sets forth the organization’s commitment to *Maintaining the Independence of the Corporate Audit* should establish board protocol for evaluating independent audit firms and specify when the board or management may engage its audit firm (or an affiliate) to perform non-audit services. This policy should incorporate several of the “audit independence” related issues contained in the recently enacted Sarbanes-Oxley Act.

j. Management Disclosure Policy. A policy on *Management’s Duty to Disclose and Report* responds to the deficiencies in the board/management relationship identified in the Powers Report. This policy goes beyond the discussion of job expectations set forth in an executive’s employment contract and identifies the specific situations in which the board expects that senior management will disclose matters to the board and seek its approval before proceeding.

2. Implement Selected Sarbanes-Oxley Provisions Now. Another step that prudent non-profit health care organizations can take to respond to corporate responsibility concerns is to implement, by internal policies or corporate controls, those provisions of the Sarbanes-Oxley Act foreseeably extendable to nonprofits. While the Act only applies to public companies, regulatory bodies with jurisdiction over charitable organizations are beginning to publicly acknowledge its relevance. Indeed, many of the specific provisions of the Act appear readily applicable to nonprofits, and their adoption now would constitute a forward-thinking organizational response to legal or regulatory scrutiny.

Some of the recommendations below are slightly modified versions of provisions of the Sarbanes-Oxley Act, which modifications make the requirements more practical for nonprofits. We recognize that each organization’s circumstances may vary and that not every suggestion below will be appropriate for every organization. The provisions of the Act that should be considered for early implementation by any large nonprofit corporation include the following:

a. Audit Committee (Secs. 205, 301, and 407). Establish a dedicated audit committee of the board for the purpose of overseeing the accounting and financial reporting processes of the corporation and audits of its financial statements. Establish specific duties and obligations of the audit committee and standards and qualifications for membership thereon (*e.g.*, outside directors). Consider requiring at least one member to be specifically knowledgeable about financial reports.

b. Auditing, Quality Control, and Ethics Standards (Sec. 103). Confirm that the corporation’s independent auditor is in compliance (and will for the duration of the audit process, comply) with the rules concerning auditor professional conduct (*e.g.*, auditing and related attestation standards, quality control standards, and ethics standards) that are established by the new Public Company Accounting Oversight Board.

c. Auditor Independence (Secs. 201, 202). Develop internal policies (1) prohibiting the corporation from purchasing from its audit firm certain specific non-audit consulting

services contemporaneously with an audit, and (2) establishing an advance approval process for the engagement of the audit firm to provide other, non-prohibited, non-audit services.

d. Audit Partner Rotation (Sec. 203). Require the rotation of the lead audit partner and reviewing partner for the corporation's audit (**not** rotation of the audit firm) every five years.

e. Auditor Reports to Audit Committee (Sec. 204). Confirm that the corporation's independent auditors will timely report to the audit committee of the corporation: (1) all critical accounting policies to be used, (2) all alternative treatments of financial information (within GAAP) that have been discussed with senior management, the ramifications thereof, and the preference of the auditor, and (3) other material written communication between the independent auditor and senior management (*e.g.*, any agreement, letter, or schedule of unadjusted differences).

f. Audit-Related Conflict of Interest (Sec. 206). Apply conflict of interest screens as necessary to prohibit an audit firm engagement where the CEO, CFO, controller, chief accounting officer or person(s) holding an equivalent position with the corporation was previously employed by the prospective audit firm and participated in any capacity with the corporation's audit during the one-year period preceding initiation of the audit.

g. Corporate Responsibility for Financial Reports (Sec. 302). Develop an internal process that would facilitate the ability of the principal executive officers of the corporation to certify the corporation's periodic financial reports should relevant law ultimately be adopted to require such certification by nonprofit corporations. Section 302 certification requires CEOs and CFOs to certify that: (1) the signing officers have reviewed the report, (2) to the knowledge of the signing officers, the report does not contain any untrue statement of material fact or omit a material fact necessary in order to make the statements made not misleading, and (3) to the knowledge of the signing officers, the financial statements, and other financial information included, fairly present, in all material respects, the financial condition, results of operation, and cash flows of the company as of and for the periods presented in the report. In addition, Section 302 requires certifications concerning internal controls and disclosures to auditors.

h. Improper Influence on Conduct of Audits (Sec. 303). Adopt a corporate policy prohibiting any corporate officer or director from directly or indirectly taking any action to apply improper influence with respect to the corporation's independent audit firm or an employee thereof engaged in the audit process.

i. Forfeiture of Certain Compensation (Sec. 304). Revise corporate executive compensation guidelines as necessary to require reimbursement to the corporation of financial performance-based incentive compensation in the event of a subsequent restatement (or other material revision) of corporate financial reports.

j. Rules of Professional Responsibility for Attorneys (Sec. 307). In-house counsel should advise the board and senior management of the evolving nature of professional responsibility rules and related ethical standards with respect to the obligation of corporate counsel to disclose to appropriate corporate officials evidence of material violations of law or breach of fiduciary duty by the corporation or any agent thereof.

k. Enhanced Financial Disclosures (Sec. 401). Confirm with the corporation's independent auditor that all financial reports for the corporation will reflect all material correcting adjustments that have been identified by the audit firm, as well as all material "off balance sheet" transactions and arrangements.

l. Enhanced Conflict of Interest Provisions (Sec. 402). Expand existing corporate conflicts and compensation policies to incorporate prohibitions on the making of personal loans or credit extensions to directors or officers of the corporation.

m. Management Assessment of Internal Controls (Sec. 404). Senior management should be requested to incorporate within the corporation's annual report an internal control report that would (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (2) contain an assessment (as of the end of the corporation's most recent fiscal year) of the effectiveness of the internal control structure and procedures of the corporation for financial reporting. The corporation's independent auditor should be requested to report on, and attest to, management's assessment.

n. Code of Ethics for Senior Financial Officers (Sec. 406). The corporation should adopt a code of ethics for its senior financial officers (*e.g.*, principal financial officer and comptroller or principal accounting officer, or persons performing similar functions). The code is intended to promote: (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships, (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the corporation, and (3) compliance with applicable government rules and regulations.

o. "Real Time" Disclosures (Sec. 409). As may be appropriate, consider enhanced public disclosure, in "plain English" and on a "rapid and current basis," of information concerning material changes to the corporation's financial condition or operations.

p. Document Policies (Sec. 802). Revise corporate policies on document retention to comply with new rules and prohibitions governing the destruction, alteration, or falsification of corporate records.

q. Whistleblower Protection (Sec. 806). Re-evaluate internal protocols extending employment status and related protections (*e.g.*, protection against retaliatory discharge or other adverse employment action) to corporate employees who lawfully provide the board or governmental agencies with information regarding conduct that the employee reasonably believes violates existing law.



Part III: Conclusion

Coalition members and other leading nonprofit organizations should seriously evaluate the current corporate responsibility environment, monitor additional financial or accounting scandals as they evolve in the press and in court, and be mindful of reasonably anticipated political and public policy fallout. Nonprofit trustees and directors should not interpret the corporate responsibility environment as a reason to abandon voluntary board service due to associated liability risks. There has been no “sea-change” in the fundamental standards of fiduciary duty in response to Enron and its progeny. Moreover, there is no reason to believe that the corporate responsibility environment will turn a healthy board/management relationship into an adversarial relationship. In contrast, by making relationships and expectations clearer and sensitizing all players to the importance of their roles, the emerging corporate responsibility environment, and nonprofit health care organizations’ appropriate responses to it, will only strengthen those relationships for the benefit of all.

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