I. INTRODUCTION

It remains to be seen whether the changes in Congressional Committee leadership resulting from last November’s elections will impact governance issues for the higher education and non-profit sectors. The former chair of the Senate Finance Committee, Charles Grassley, seemed to be interested in governance issues, and his staff created a stir in the non-profit community with a number of their proposals. Perhaps the most controversial was a proposal to limit board size. Indeed, Senator Grassley opined that the Red Cross’ 40+ board was too large. However, legislation to enact the staff’s proposal was not introduced in 2006.

The January 22nd e-mail edition of *The Chronicle of Philanthropy* described the interest of various non-profit sectors in the budget process. The new Democratic leaders indicated that they would seek to provide funding in 2007 at the same level as 2006 while perhaps providing additional funding where the status quo create severe hardship.

The prohibition on earmarks will impact the non-profit sector. Earmarking is a ploy that has become popular with certain colleges and universities in recent years. And
perhaps lagging cookie sales caused the Girl Scouts to obtain a $2.1 million earmark last year for several juvenile justice programs.

At the state level, the movement to enact Sarbanes-Oxley inspired legislation affecting large non-profits seems to have stalled. California’s lead has not been followed elsewhere.

II. RECENT DEVELOPMENTS

A. Pension Protection Act of 2006

On August 17, 2006 the Pension Protection Act (“PPA”)\(^1\) became effective. The legislation affects colleges and universities in several ways. First, the PPA subjects Form 990-T “Exempt Organization Business Income Tax Return” to public disclosure. The 990-T is the tax return on which tax-exempt organizations report their unrelated business income. This development will likely invite more focused public scrutiny of the profitability and related expenses of the business activities of colleges and universities as evident by the 2007 IRS work plan. On November 7, 2006, the Internal Revenue Service released its 2007 work plan. The work plan notes that one of its projects will focus on the unrelated business income of colleges and universities. The project will analyze how colleges and universities allocate and report unrelated business income expenses. It is likely that the Service will review research activities, licensing and technology transfers, athletics, sponsorship, and advertising, and alternative investments.

In addition to the unrelated business income issues, the PPA also impacts colleges and universities that have foundations that are classified by the Service as tax-exempt under Section 501(c)(3) and as supporting organizations under Section 509(a)(3) of the Code. Many private foundations are restricted from making grants to non-profits known as “Type III supporting organizations” (now described in Code sections 509(a)(3)(B)(iii) and 4943(f)(5)(A)) unless they are

\(^1\) H.R. 4, Public Law 109-280
Most private foundations will now require documentation from colleges and universities of the sub-classification status of these supporting organizations before a grant will be made. In Notice 2006-109 the Treasury Department provided guidance as to criteria private foundations can use to determine for purposes of sections 4942(g)(4) and 4945(d)(4) whether an organization is a Type I, Type II, or functionally integrated Type III supporting organization. In general, supporting organizations have been identified by the type of relationship they have with their publicly supported organizations. Section 4966(d)(4)(B)(i), new to the Internal Revenue Code, defines a Type I supporting organization as a supporting organization that is operated, supervised, or controlled by one or more section 509(a)(1) or 509(a)(2) organizations. New section 4966(d)(4)(B)(ii) defines a Type II supporting organization as a supporting organization that is supervised or controlled in connection with one or more section 509(a)(1) or 509(a)(2) organizations. (See also sections 4942(g)(4)(B)(i) and (ii) for parallel definitions of Type I and Type II supporting organizations). Finally, new section 4943(f)(5)(A) defines a Type III supporting organization as a supporting organization that is operated in connection with a section 509(a)(1) or (2) organization.

New section 4943(f)(5)(B) defines a functionally integrated Type III supporting organization as one which is not required to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.

New section 509(f)(2), provides that any organization that would otherwise meet the requirements of a Type I or Type III supporting organization

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2 [A “functionally integrated type III supporting organization” is defined in Code section 4943(f)(5)(B) as “a type III supporting organization which is not required under regulations established by the Secretary to make payments to supported organizations (as defined in section 509(f)(3)) due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.” The current regulations referenced by this definition are found in Treasury Regulations section 1.503(a)-4(i)(3)(ii).] OR [A “functionally integrated type III supporting organization” is defined in Code section 4943(f)(5)(B), with reference to Treasury Regulations section 1.503(a)-4(i)(3)(ii).]
will be excluded under this provision if it accepts any gift or contribution from a person who directly or indirectly controls (either alone or together with related persons described in section 509(f)(2)(B)(ii) and (iii)) the governing body of a supported organization of such supporting organization or from a related person described in section 509(f)(2)(B).

Until further guidance is issued, for purposes of sections 4942, 4945, and 4966 (as applicable) a grantor, acting in good faith, may rely on information from the IRS Business Master File (“BMF”) or the grantee’s current IRS letter recognizing the grantee as exempt from federal income tax and indicating the grantee’s public charity classification in determining whether the grantee is a public charity under section 509(a)(1), (2), or (3). In addition, a grantor, acting in good faith, may rely on a written representation from a grantee and copies of the public charity’s governing documents below in determining whether the grantee is a Type I, Type II, or functionally integrated Type III supporting organization. The good faith requirement is not satisfied if the collected specified documents are inconsistent with the written representation. In each case, the grantor must verify that the grantee is listed in Publication 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, or obtain a copy of the current IRS letter recognizing the grantee as exempt from federal income tax.

3 A. To establish that a grantee is a Type I or a Type II supporting organization, a grantor, acting in good faith, may rely on a written representation signed by an officer, director or trustee of the grantee that the grantee is a Type I or Type II supporting organization, provided that:
   i. the representation describes how the grantee’s officers, directors, or trustees are selected, and references any provisions in governing documents that establish a Type I (operated, supervised, or controlled by) or a Type II (supervised or controlled in connection with) relationship (as applicable) between the grantee and its supported organization(s); and
   ii. the grantor collects and reviews copies of governing documents of the grantee (and, if relevant, of the supported organization(s)).
B. To establish that a grantee is a functionally integrated Type III supporting organization a grantor, acting in good faith, may rely on a written representation signed by an officer, director or trustee of the grantee that the grantee is a functionally integrated Type III supporting organization, provided that:
   i. the grantee’s representation identifies the one or more supported organizations with which the grantee is functionally integrated;
   ii. the grantor collects and reviews copies of governing documents of the grantee (and, if relevant, of the supported organization(s)), and any other documents that set forth the relationship of the grantee to its supported organizations, if such relationship is not reflected in the governing documents; and

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7 - McKiernan, Ruger - Responsibility and Accountability etc (3).doc
As an alternative to relying on a written representation from a grantee, a grantor may rely on a reasoned written opinion of counsel of either the grantor or the grantee concluding that the grantee is a Type I, Type II, or functionally integrated Type III supporting organization.

A private foundation considering a grant to a Type I, Type II, or functionally integrated Type III supporting organization may need to obtain a list of the grantee’s supported organizations from the grantee to determine whether any of the supported organizations is controlled by disqualified persons of the private foundation.

B. Board Best Practices in a Post Sarbanes Oxley World

A challenge that Boards face in the Sarbanes Oxley environment is that excessive meeting time is devoted to compliance issues. For many college and university Boards this emphasis on compliance, albeit necessary, does not provide the Board with ample time to think about strategic issues.

i. Richard Chait, in the book Governance as Leadership: Reframing the Work of Nonprofit Boards offers a governance model that includes three modes of governing. The first is fiduciary governance. To Chait, this is the fundamental role of a Board in its duties of loyalty and care that attention is devoted to “financial discipline, informed oversight, mission fidelity, and primacy of organizations’ interests.” In fiduciary governance the Board oversees operations, ensures effect and appropriate use of resources and ensures legal and fiscal compliance and accountability. Chait challenges Boards to not only model fiduciary governance, but to include strategic and generative governance as well. Strategic governance requires Boards to evaluate the institution’s strategies – to scan the environment, set priorities, review and modify the strategic plan and to monitor performance against the plan. Generative governance takes strategy a step farther – Boards are challenged to think more abstractly – what is the next big idea, what is the vision 10, 15 or 20 years from now.

BoardSource recently published The Source: Twelve Principles of Governance That Power Exceptional Boards. These principles can assist Boards
as they challenge themselves to not only meet their fiduciary responsibilities, but also think strategically and generatively. Exceptional boards follow these principles:

1. **Constructive Partnership**: govern in constructive partnership with the chief executive, recognizing that the effectiveness of the board and chief executive are interdependent.

2. **Mission Driven**: shape and uphold the mission, articulate a compelling vision, and ensure the congruence between decisions and core values.

3. **Strategic Thinking**: allocate time to what matters most and continuously engage in strategic thinking to hone the organization's direction.

4. **Culture of Inquiry**: institutionalize a culture of inquiry, mutual respect and constructive debate that leads to sound and shared decision making.

5. **Independent-Mindedness**: when making decision, board members put the interests of the organization above all else.

6. **Ethos of Transparency**: promote an ethos of transparency by ensuring that stakeholders have access to appropriate and accurate information regarding finances, operations and results.

7. **Compliance with Integrity**: promote strong ethical values and disciplined compliance by establishing appropriate mechanisms for active oversight.

8. **Sustaining Resources**: link bold visions and ambitious plans to financial support, expertise, and networks of influence.

9. **Results Oriented**: measure the organization's advancement towards mission and evaluate the performance of major programs and services.

10. **Intentional Board Practices**: structure themselves to fulfill essential governance duties and to support organizational priorities.
11. **Continuous Learning**: evaluate their own performance and assess the value they add to the organization.

12. **Revitalization**: energize themselves through planned turnover, thoughtful recruitment, and inclusiveness.

Clearly a Board must first deal with its fiduciary responsibilities, its compliance and oversight roles, before it can devote time and energy for charting new horizons for the institution and for itself. However, the missions of our colleges and universities are critical to our future. Boards need to be challenged to embrace the principles of exceptional boards.

### III. AGB STATEMENT ON BOARD ACCOUNTABILITY

Undoubtedly influenced by well publicized governance failures at American University, The Medical College of New Jersey and elsewhere, the Association of Governing Boards of Universities and Colleges (“AGB”) issued its Statement on Board Accountability (“Statement”) on January 18, 2007. The Statement observes that widespread concern among the public and public officials regarding governance and accountability in higher education has created “. . . a sense of urgency about responding to such concerns before rigid external regulation preempts responsive internal action.” In short, the Statement suggests that the failure to address accountability issues will lead to federal or state regulation that will probably be onerous and in derogation of institutional independence. In the words of the Statement, the following conditions prevail:

- “Growing pressure on many sectors of the non-profit community for greater accountability presents a compelling opportunity to address this issue.

- Changes in the legal and regulatory environment (exemplified by Sarbanes-Oxley legislation), though largely designed to address problems in the corporate sector, are not irrelevant to higher education.

- Lapses and failures in the integrity and governance of certain participants in the non-profit and higher education communities – particularly in such
areas as conflict of interest, executive compensation, and financial oversight – have raised troubling questions.

- Increased scrutiny from congressional committees and state officials, and a litigious environment that affects all colleges and universities, call for clear articulation of the principles of autonomy and authority of governing boards.”

The Statement examines accountability in four “dimensions:” fiscal integrity; board performance; educational quality; and presidential search, assessment, and compensation. Among recommendations are the following:

- Regularly monitor trustee compliance with the board’s conflict-of-interest policy to prevent trustees from benefiting or appearing to benefit from their service in inappropriate ways.
- In the case of public universities, require that all board and committee sessions are conducted in public, with the exception of those dealing with sensitive matters such as personnel, real-estate transactions, pending negotiations, and legal consultations.
- Require all new trustees to attend a comprehensive orientation program.
- Determine that systematic and rigorous assessments of the quality of all educational programs are conducted periodically.
- Lead an annual assessment of presidential performance on the basis of clearly defined, mutually agreed-upon goals.
- Base presidential compensation on explicit and justifiable benchmarks from within and outside the institution.

Finally, the Statement delineates a governing board’s basic responsibilities.

Accountability naturally flows from the board’s basic responsibilities:

- Approve the mission and purpose of the institution.
- Recruit, appoint, support and evaluate the chief executive officer.
- Guard the fiscal integrity of the institution:
  - Consider and approve the institution’s budget.
  - Monitor the resources and productivity of the institution.
Manage the institution’s endowment (in many public institutions and systems, this responsibility is delegated to an affiliated foundation).

Participate in fund-raising, both through personal philanthropy and advocacy.

Ensure that annual independent audits are conducted.

Meet the expectations of board accountability and transparency in the conduct of board affairs.

- Oversee and participate in periodic strategic planning and monitor progress on its outcomes.
- Be aware of educational, research, and service programs and demand evidence that the institution’s academic priorities are being met.
- In concert with the senior administration, engage with the institution’s major constituencies on a regular basis.
- Preserve institutional independence to protect the pursuit of truth, the generation of new knowledge, and intellectual inquiry so that they remain unencumbered by direct government control of special interest.
- Remain informed about institutional issues and the challenges confronting higher education.
- Serve, as necessary, as a final court of appeals on matters relating to governance and on institutional policies and practices in accordance with campus grievance procedures.

If these principles seem familiar, they are adaptations, for higher education, of the basic board duties of care and loyalty. These duties, and their foundations in law, are described in greater detail in the outlines on board responsibilities and governance principles prepared by the speakers for their 2005 and 2006 Stetson presentations.

Copies of the Statement are found at www.agb.org/accountability.