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Emerging Governance Standards for Higher Education Entities

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I. INTRODUCTION

Below is an abridged version of a final exam question in the Nonprofit Organizations course at the St. Louis University Law School:

An article in the November 21, 2004 *New York Times* began:
"Turmoil Grips Elite School Over Money and Leaders; State Inquiry at St. Paul's Spurs Changes"

> Critics say the school has spent large sums on consultants with past connections to school officials, failed to properly disclose certain costs and invested its endowment in a way that has driven up expenses. Some of the anger is directed at the president because of his hefty pay package and spending on the rectory, even while faculty benefits were cut.

Assume that the school, a private secondary school organized as a secular not-for-profit corporation with 501(c)(3) status, is under scrutiny by the Missouri Attorney General and a group of school alumni, parents and donors. Generally, they are concerned that the current Board and administration have not fulfilled their legal and ethical responsibilities.

Specifically, they question the following:

(a) Annual spending, for several years of about $900,000 on consultants with business relationships to board members and, in some cases, fees being paid to board members' firms.

(b) Paying the school's president (chief executive) annual compensation of $452,000, a sum much more generous than paid his counterparts at similar schools.

(c) The board, within the last 5 years, has authorized $1,200,00 for renovations and redecorating of the president's home.

(d) The niece of a major donor and board member was recently hired, at an annual salary well above that at comparable schools, to be the school's fund-raising chief. The board, with her uncle present, approved the hiring without discussion. The uncle did not disclose his relationship with the candidate to the board at any time.

(e) The full board, consisting of 36 members, meets only twice a year. Generally, the full board hears reports from the president and the executive committee and does not initiate action on its own. It does approve appointments of the school's important personnel. A 3-person executive committee meets monthly and makes the major decisions affecting the school. However, it meets only with the president and almost always defers to the president and agrees, with little inquiry, to his proposals.

If any of the situations described are occurring at your campus or organization, you have come to the right session.

Interest in corporate governance issues is very high today for both profit and nonprofit entities. Enron, Tyco, WorldCom, Health South and Adelphia have become common synonyms for greed, excess and the flaunting of ethical and legal principles. Commissioner Harvey J. Goldschmid of the U.S. Securities and Exchange Commission, in a September 30, 2004 address to the Missouri Bar's annual meeting, described what went wrong with corporate governance. The factors he cited were:

A. Inadequate Independent Directors.

Steven Cutler, the Director of the Division of Enforcement at the SEC observed: "Too often, boards were disinterested and disengaged. . . . . They are dominated by associates and friends of senior management. . . . . Many outside directors have lacked expertise in the relevant industry, and in accounting and financial reporting issues. Thus, board were too rarely equipped to uncover and derail the determined efforts of management to cook the company's books."

B. Lack of Auditor Independence.

Compounding the problem of directors being inadequately informed was the failure of others (auditors, lawyers, investment bankers) serving the entity to disclose operational issues. And, in corporate governance just as in universities, the gatekeepers to the information (the administration) did not adequately inform the directors.

Compounding the problem of director inadequacy was the generally accepted view that, except for gross negligence or misconduct, corporate directors generally were insulated from personal liability for their acts of malfeasance, misfeasance, and nonfeasance. During the '80s and '90s businesses turned more and more often to their auditors for help with non-audit services. Goldschmidt observed: "But when an accounting firm provides both audit and extensive consulting services to an audit client, the auditor's independence may well suffer, particularly when the consulting services are significantly more lucrative and more voluminous than the audit services. An auditor who wants to retain an audit client's non-audit business may be less likely to question management, and that is a serious problem." Added to this was a failure of professional self-regulation. As to lawyers, he noted: "On the lawyers, space does not allow me to focus on the changes in the culture and economic structure of the legal profession. But for present purposes, I need only paraphrase Judge Stanley Sporken in the *Lincoln Savings* case: “During the most dramatic financial scandals that have occurred during my professional life, where were the lawyers?”

C. Regulatory Policy.

An additional factor to which the scandals were partially attributable was the less stringent legal and regulatory climate of the ‘90s and early 2000s. In 1994 the U.S. Supreme Court eliminated aiding and abetting liability in securities cases, and shortened the statute of limitations for securities fraud.

In addition to the criminal prosecution of corporate malefactors, the principal Congressional response to the corporate scandals was the passage of the Sarbanes-Oxley Act. That Act will be analyzed in greater detail shortly. For now, let us simply note that its objectives are to bring a high degree of accountability and transparency to corporate transactions, and to eliminate the conflict of interest inherent in certain service provider and director rules.

The nonprofit world, including colleges and universities, have had their scandals, too. The national United Way, the D.C. United Way and Adelphi University provide examples of shameful conduct. Many nonprofit groups have adopted governance reflecting Sarbanes-Oxley principles. See *The Chronicle of Philanthropy*, August 19, 2004, pages 6-10. Legislation has been introduced in several states to impose the principles on nonprofits. Proposals from the U.S. Senate’s Finance Committee and recent IRS action on conflict of interest have been generated by Sarbanes-Oxley. The National Association of College and University Attorneys has sponsored several programs on the applicability of the Act.

Certainly, as a result of governance failures in both the profit and nonprofit sectors, there is renewed interest in the responsibilities of board members. Even if the same terms are used to describe those responsibilities (e.g., “business judgment rule”; “good faith”; “in the best interests of the corporation") their content, and the degree of diligence associated with their exercise will no doubt be enhanced. An examination of the current interpretation of board member responsibilities follows:

II. RESPONSIBILITIES OF DIRECTORS AND TRUSTEES

The board of directors is responsible for directing and managing the affairs of the nonprofit corporation. The former President of Princeton University, William G. Bowen, in Inside the Boardroom, suggests that boards of directors serve six principal functions:

(1) to select, encourage, advise, evaluate and, if need be, replace the chief executive officer;

(2) to review and adopt long-term strategic directions and to approve specific objectives, financial and other, such as reviewing the basic mission of the organization in light of changed circumstances;

(3) to assure to the extent possible that the necessary resources, including human resources, will be available to pursue the strategies and achieve the organization's objectives;

(4) to monitor the performance of management;

(5) to ensure that the organization operates responsibly as well as efficiently; and

(6) to nominate suitable candidates for election to the board, and to establish and carry out an effective system of governance at the board level, including evaluation of board performance.

Directors deal with a plethora of issues, usually significant, but sometimes trivial, in assisting their organization.

A. Standards of Conduct for Directors

A review of judicial decisions from the 1960s on, and nonprofit corporation statutes enacted in the late 20th century, traces an evolution from a trust standard (directors of a Missouri nonprofit corporation were held to"…a standard of scrupulous good faith in the fiduciary role as guardians of the corporate welfare,") to the lesser standard of the "business judgment" rule. The trust standard made the trustees potentially liable for ordinary negligence, limited delegation of responsibility and prohibited transactions between the trustee and the entity. When the "business judgment" standard is applied, directors are not liable for mistakes in judgment, so long as they were taken in good faith and in what the director reasonably believed to be in the best interests of the nonprofit corporation. Gross negligence may be required for liability. Directors may engage in transactions with the nonprofit so long as appropriate disclosure occurs. The "Sibley Hospital" case provided impetus to the adoption of the "business judgment" standard. Among other contentions, the plaintiffs claimed that five trustees with ties to local banks sought to enrich themselves at the expense of the hospital by maintaining unnecessarily large amounts of money on deposit with their banks, drawing inadequate or no interest. In short, the trustees were charged with mismanagement, nonmanagement and self-dealing. The court, searching for a standard, deemed the law unsettled and then compared their functions to those of for-profit corporations and found them virtually indistinguishable. In addition, the responsibility of the traditional trustee was regarded as a limited role, often only the management of the trust assets. The "less stringent" corporate standard of care articulated in "Sibley" requires directors of nonprofit corporations " . . . . to exercise ordinary and reasonable care in the performance of their duties, exhibiting honesty and good faith." *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974).

The American Bar Association, in § 8.30(a) of its Model Nonprofit Corporation Act, codified the standards derived from "Sibley":

"A director shall discharge his or her duties as a director . . . :

(1) in good faith;

(2) with the care an ordinary prudent person in like position would exercise under similar circumstances; and

(3) in a manner the director reasonably believes to be in the best interest of the corporation."

The "standards" provision specifically states that "a director shall not be deemed to be a trustee with respect to the corporation . . . " or any of its property. To satisfy these standards of conduct, directors of nonprofit corporations must fulfill the duties of care, loyalty and obedience.

1. Duty of Care

The duty of care requires a director to be well informed and reasonable when participating in a board's decision making. Appointment to a board is more than an honorific gesture. Use of independent judgment is critical: too often board members, particularly in large nonprofits, "rubber stamp" the recommendations of management without necessary inquiry. The indicia of prudent board member behavior include: regular attendance at board and committee meetings; careful examination of financial statements; acquisition of a working knowledge of the nonprofit's mission and policies; and making appropriate inquiries to staff and fellow board members. One's objective is to discharge their responsibilities in a reasonable, prudent and informed way.

Reliance on statements and data from staff or other board members believed to be reliable and competent satisfies the duty of care, as does reliance on information and opinions of legal counsel or accountants. In religious organizations, directors may rely on statements and data from ministers, priests, rabbis or other clergy” . . . or other persons whose position or duties in the religious organization the director believes to justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented.” The scope of protection provided by the “business judgment” rule, generally applicable to directors of nonprofit organizations, insulates a director from liability”. . . to the corporation, any member, or any other person for any action taken or not taken as a director, if the director acted . . .” in good faith, as an ordinarily prudent person and with a reasonable belief that the decision is in the entity’s best interest. Perfection in judgment is not expected.

To enhance its ability to make informed decisions, board members should insist that relevant information is provided on a timely basis and that access to outside advisors can occur. Directors should be persistent in their efforts to make appropriate inquiries, do due diligence and confirm that major transactions are financially reasonable and are consistent with the educational purposes of the organization.

2. **Duty of Loyalty**

This duty imposes a standard of faithfulness to the organization. Its interest must be paramount, and undivided allegiance to the organization must occur in the board's decision-making process. Specific issues associated with this duty are conflict of interest and confidentiality. Personal gain, or the appearance of gain, at the entity's expense must be avoided.

For example, the Missouri Nonprofit Corporation Act (based in large part on the Model Act) addresses conflict of interest. A conflict of interest occurs when a director has a material financial or personal interest in the impending transaction with the corporation. Section 355.416 Mo. Rev. Stat. For example, if the entity were considering hiring a director’s relative or obtaining services from the director’s firm, a potential conflict of interest exists.

This is an age of accountability: accordingly, directors must be aware of both the substance of a conflict and its appearance to the community. Nonprofit organizations depend upon community support and always must be wary of creating an impression that resources derived from the public are unreasonably profiting board members or their families. Indeed, to maintain federal income tax exempt (§501(c)(3)) status, a nonprofit organization must avoid "private inurement" and "self-dealing."

Disclosure is the essential first step in addressing a potential conflict of interest situation. Indeed, the relevant Illinois statute (805 ILCS 105/108.60) creates presumption of fairness in favor of an interested director if disclosure occurs and the transaction is approved by the directors not having a conflict of interest. The director, as soon as becoming aware that his or her personal or financial interest might be impacted by a potential board action, should disclose to the board that interest. Board minutes should reflect that disclosure. The director should also refrain from voting on the transaction at issue and, again, the minutes should reflect this action. While not required by statute, a good practice is for the director involved in the transaction to leave the meeting so that the rest of the board can freely discuss the issues. Following full disclosure, the board may approve the transaction, provided they find it to be in the corporation's best interest. Under these circumstances, duty of loyalty would be met.

Many boards find it desirable to go beyond the foregoing procedure to further negate the appearance of conflict of interest. Requests for proposals, often quite simple in nature, are frequently sent to potential service providers. This procedure allows the board to compare potential providers and choose one best suited to the board's needs. Other boards are more stringent and prohibit transactions with board members, as many public bodies do.

The board should develop a conflict of interest policy, possibly for the inclusion in the bylaws. Board members should also be aware of the concept of corporate opportunity and pledge not to appropriate what is rightfully the nonprofit's. Board members should also be aware that it is inappropriate for them to ask staff to further their interests when it may not be in the organization's best interest. In extreme cases, the office of the Attorney General or Internal Revenue Service may challenge the board's actions, particularly when the conflict of interest is flagrant. The publicity associated with such actions will be destructive, perhaps fatal, to the afflicted organization.

Recent decisions in Missouri and Illinois provide examples of the bad publicity and financial liability that can occur when directors ignore their duty of loyalty and seek to profit to the detriment of their nonprofit corporation. In *Nixon v. Lichtenstein*, 959 S.W. 2d 854 (Mo. Ct. App. E.D. 1997) the Missouri Attorney General sued to remove two directors from the board of a charitable corporation and obtain reimbursement for funds expended on their behalf. While the facts indicated a violation of the business judgment rule, the court of appeals did not reach that issue because it concluded that the nonprofit corporation succeeded a charitable trust and had assumed the stricter standards of the trust. Finding that the directors had breached their fiduciary duties, the court cited numerous examples of their breach of the duty of loyalty, including paying excessive compensation; purchasing personal property and travel with the nonprofit's funds; installing a phone in every room in a director's home at the nonprofit's expense; and, attempting to conceal improper personal property purchases.

An Illinois decision castigated two directors of a nonprofit who sought to enrich themselves in a property transaction with the nonprofit. The court prevented them from profiting from their wrongdoing, clearly stating their attempt to sell property to a nonprofit, without disclosing their interests, breached their fiduciary responsibilities. *White Gates Skeet Club v. Lightfine*, 658 N.E. 2d 864 (Ill. Ct. App. 1995).

Another aspect of the duty of loyalty is the duty of the director to refrain from disclosing information about the corporation's activities unless they are a matter of public record. Boards need to deliberate in confidence and with candor.

3. Duty of Obedience

While some include the duty of obedience within the duty of loyalty, it is important enough to stand alone. To satisfy this duty, a director must ensure that the nonprofit organization conforms, or remains obedient, to its purposes as described in the articles of incorporation. Today this encompasses more than preventing *ultra vires* activity: it is a corporate compliance function. Directors must enhance the stated mission of the nonprofit while concurrently seeking to insure that it is operating in accordance with applicable law. An aspect of this duty is assuring donors that their contributions will be used as they specify and for the stated purposes of the organization.

B. Future of the "Business Judgment" Rule

An outgrowth of the recent corporate scandals will undoubtedly be an elevated business judgment standard. Courts undoubtedly will apply stricter and more scrupulous scrutiny to what is reasonable, prudent, in good faith, and in the best interests of the nonprofit corporation. Discretion will undoubtedly be curtailed.

Federal legislation enacted in response to corporate wrongdoing will have an effect on the nonprofit sector. For example, the Sarbanes-Oxley Act of 2002, while principally addressing the corporate accounting scandals of 2002, suggests public policy principles applicable to nonprofit entities. The impact, according to presenters at a recent NACUA conference, could include: "closer scrutiny and questioning of institutional transactions and relationships by board members. . ."; "more rigorous review of transactions and financial statements by institutional auditors…"; more aggressive oversight, auditing and enforcement litigation by the

IRS and state attorneys general; and "the use of Sarbanes-Oxley. . .as an impetus. . ." for future nonprofit legislation and standards of . . . "conduct by directors and officers in the nonprofit sector."

In light of recent revelations of misconduct by major corporations, including some in the nonprofit sector, and the apparent concurrent inattention by the boards of those entities, one can expect an elevation of the "business judgment" standard and an increased emphasis on a director's obligation to fulfill the duties of care, loyalty and obedience.

III. CONFLICTS OF INTEREST

At last year's Stetson conference, Peter Ruger addressed conflicts of interest. The major emphasis of that session was dealing with conflicts at the faculty and staff level. A copy of his outline is included, as Appendix A, with these materials.

For decades, observers of university governance practices have encouraged the adoption of a conflict of interest policy, and most institutions have such policies. Indeed, for trustees of many public institutions, an absolute prohibition against institutional transactions with trustees (or their families) exists.

Policies addressing and managing conflict of interest issues, and prohibiting the appropriation of corporate opportunity, are necessary to maintain public and institutional confidence, and to comply with law. Heightened scrutiny by the state and federal government can be expected. One example was Illinois' recent enactment of ethics legislation affecting state employees, including those serving colleges and universities.

In addition to legislative and regulatory efforts to impose the principles of Sarbanes-Oxley on the nonprofit sector, the Internal Revenue Service has signaled its greater interest in conflict of interest issues by recent changes to Form 1023, the lengthy form used by nonprofits to apply for tax-exempt (Section 501(c)(3)) status. Three new questions and a lengthy sample policy have been added.

The questions, which are also relevant to existing organizations, are:

a. “Have you adopted a conflict of interest policy in Appendix A to the instructions?”

If no, answer the following:

b. “What procedures will you follow to assure that persons who have a conflict of interest will not have influence over you for setting their own compensation?”

b. What procedures will you follow to assure that persons who have a conflict of interest will not have influence over you regarding business deals with themselves?”

If the current Congressional interest in the periodic review of tax-exempt status becomes law, the IRS questions and policy will have widespread impact. The increased interest displayed by the IRS in conflict issues will no doubt be reflected in audits of nonprofits in the future.

The Association of Governing Board (AGB), in its 2001 paper, *Governing in the Public Trust*, urges trustees and directors to “exhibit exemplary public behavior.” As part of this principle, the AGB urges “strict avoidance of conflicts of interest, and commitment to board self-regulation….Policies should clearly specify the responsibilities of boards and individual members while emphasizing collective and individual accountability.” In addition to enhanced scrutiny and concern by boards to avoid conflicts of interest, we will undoubtedly see increased oversight of these issues by attorneys general, the IRS and other regulatory bodies.

IV. SARBANES-OXLEY ACT

The American Competitiveness and Corporate Accountability Act of 2002, commonly known as the Sarbanes-Oxley Act (“SOA”), was signed into law on July 30, 2002. Passed in response to corporate and accounting scandals that included Enron and Arthur Anderson, the law’s purpose was to rebuild public trust in America’s public sector.

The SOA sets forth standards for publicly traded companies to follow that significantly increase governance and the board members' responsibilities in overseeing financial transactions and auditing procedures.

At the time Congress was debating the provisions of SOA the public perceived there to be a crisis in corporate governance. By July of 2002, equity markets had lost trillions of dollars of value. Congress reacted enacting SOA. As the most sweeping overhaul of the Federal Securities law since the 1930's, SOA was intended to deal with governance failings and financial reporting improprieties, to cure accounting and audit rulemaking inadequacies, to explore areas of suspected abuse, and to sensitize all financial capitol market participants to their responsibilities[1].

With the exception of two provisions of SOA, the act does not apply to governance procedures for nonprofit entities. However, the current climate suggests that Institutions of Higher Education ("IHE") must demonstrate effective governance practices. Portions of SOA, voluntarily applied, make good sense.

Understanding the implications of SOA is critical for nonprofit entities. What follows is an over-view of first, those provisions of SOA that all entities, including nonprofits, must follow and second, an analysis of best practices concerning the provisions of Sarbanes-Oxley and their applicability to nonprofits.

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[1] SOA applies to publicly traded companies. This paper will suggest which SOA provisions institutions of higher education should incorporate into their governance practices.

SOA provides for the following:

Title I - Improved Public Company Accounting Oversight by Establishing the Public Company Accounting Oversight Board, a private sector regulator more closely overseen by the SEC than its predecessors;
Title II – Strengthen the rules of independence applicable to auditors;
Title III – Establish new rules of corporate responsibility for officers, directors and attorneys;
Title IV – Enhance and accelerate financial disclosures;
Title V - Call for new rules to deal with conflicts of interests of security analysis;
Title VI - Reinforce the SEC's resources and authority;
Title VII - Order new studies and reports about structural issues;
Title VIII – Provide new and more rigorous rules of corporate and criminal fraud accountability;
Title IX -Increase white-collar criminal penalty provisions;
Title X - Establish or increase corporate fraud penalties;
Title XI -Insist that chief executives sign corporate tax returns.

A. Applicability of Sarbanes-Oxley to all Entities

There are two provisions of SOA that apply to all corporations. Those provisions involve whistle-blower protection and document destruction.

SOA provides protections for whistle-blowers and criminal penalties for actions taken in retaliation against whistle-blowers. The act protects whistle-blowers who risk their careers by reporting suspected illegal activities. It is illegal for a corporate entity to punish the whistle-blower in any manner. Nonprofits should begin by developing procedures for handling employee complaints. A nonprofit should have a confidential and anonymous mechanism to encourage employees to report any financial management inappropriateness. Even if claims are unfounded, the nonprofit may not reprimand the employee. The law does not force an employee to demonstrate misconduct; rather a reasonable belief that fraud exists is enough to create a protected status for the employee.

The second provision that is applicable to nonprofit organizations deals with document destruction. It is prudent that a nonprofit organization have a written mandatory document retention and periodic destruction policy. This policy helps limit accidental or unintended destruction. In addition to paper files, the document retention policy should include guidelines for handling electronic files and voicemail. The policy should cover back-up procedures, archiving of documents, and regular check-ups of the reliability of the system.

It needs to be noted that if an official investigation is underway or even suspected, nonprofits should stop any document purging in order to avoid criminal obstruction charges.

B. Instructive Provisions of Sarbanes-Oxley

The next sections will deal with the provisions of Sarbanes-Oxley that do not technically apply to IHE. However, good governance practices suggest inclusion of these provisions.

1. Independent and Competent Audit Committee

SOA requires that each member of an entity's audit committee be a member of the Board of Directors and be independent. The Act defines independent as not being part of the management team and not receiving any compensation either directly or indirectly from the entity for service on the audit committee (although SOA does provide that individuals may be compensated for Board service). Additionally, entities must disclose whether they have at least one financial expert serving on the audit committee.

Prudence would suggest that nonprofits that have budgets of more than half of a million dollars and receive federal funds should conduct an audit. As suggested above, the audit committee should consist of Board members that are not compensated for their services. The audit committee should ensure that the auditing firm has the necessary skills and experience to effectively conduct the audit. Further the audit committee should meet with the auditors, review the annual audit and recommend its approval or modification to the full board. The full board should then review the annual audit and the audit committee's report and recommendation. At least one member of the audit committee should meet the criteria of being a financial expert.

2. Responsibility of Auditors

Sarbanes-Oxley contemplates that the lead and review partner of the auditing firm rotate off the audit every five years. Interestingly, this does not necessarily mean that the audit firm must change every five years. Changing the auditor is considered to be a good practice for nonprofits.

SOA requires an entity to consider how it uses its audit firm. Specifically, the audit firm should not perform non-auditing type services for the nonprofit. Further the SOA recommends that the audit firm disclose to the audit committee critical accounting policies and discussions with management. Greater disclosure of internal control practices and management's view on such encourages more informed judgments by the audit committee, more enhanced oversight by the Board and greater transparency.

3. Certified Financial Statements

Under the SOA, the Chief Executive and Chief Financial Officers must certify the appropriateness of financial statements and that those statements fairly present the financial condition and operations of the entity. Within the context of what is best practice, it is wise to have the CEOs and CFOs able to fully understand all financial statements and to make certain that they are accurate and complete, although signing off on the financial statements provides formal assurance that both the CEO and CFO have reviewed them carefully. Further, the CEO and CFO should review the Form 990 or 990 PF before it is submitted. Irrespective of whether the CEO and CFO certify the financial report, the board has the ultimate fiduciary responsibility for approving financial reports just as the financial and audit reports are reviewed by the audit committee and the Board, the Form 990 or 990 PF should also be reviewed and approved.

4. Insider Transactions and Conflicts of Interests

The SOA generally prohibits loans to any directors or executives of a company. Loans to nonprofit executives have received heightened attention by the media. It is prudent that nonprofit organizations not provide personal loans to directors or executives. If such loans are provided, they should be formally approved by the board and the process for providing the loan should be documented and the value and term of the loan should be disclosed. To guide the board and staff in independent decision-making, the organization must have a conflict of interest policy with disclosures and this policy should be enforced at all times.

5. Disclosure

SOA requires a number of disclosures including information on internal control mechanisms, corrections to past financial statements and material off-balance sheet transactions. While many of the transactions of the SOA deal strictly with publicly traded companies, all nonprofits should feel compelled to provide donors, clients, public officials, media and others with an accurate picture of their financial condition.[2]

C. The California Nonprofit Integrity Act

Effective January 1, 2005 Senate bill 1262, the California Nonprofit Integrity Act, became law[3]. This is the first legislative effort by a state to apply provisions similar to Sarbanes-Oxley to nonprofit entities. Although the statute concentrates on charitable solicitation and issues of the use of professional fundraisers, it does include reporting and disclosure requirements. The legislation applies to charitable corporations that have annual revenue in access of two million dollars and that are required to file reports with the states' attorney general (therefore the Act does not apply to institutions such as hospitals, colleges and universities).

[2] See Society for Nonprofit Organizations January 2003 / February 2003 Vol. 21, no. 1, page 6.
[3] 2004 Cal ALS 919; 2004 Cal SB 1262; Stats 2004 ch. 919.

The California statute is instructive for several reasons. First, it is the first attempt by a state to more closely regulate entities not subject to SOA. This statute could become a model for other states wanting to impose Sarbanes-Oxley like requirements on nonprofits. Second, the voluntary sector has had little regulation other than the Internal Revenue Service and the states' attorney generals. The California statute may begin a wave of interest in regulating nonprofits.

The California statute includes the following Provisions: 1.) charities have annual financial statements prepared using generally accepted accounting principles that are audited by an independent certified public accountant; 2.) incorporated charitable organizations must have an audit committee; 3.) the board of the charitable organization must review and approve compensation paid to the President, Chief Executive Officer, Treasurer or Chief Financial Officer; and 4.) the board must ensure that the compensation is reasonable.

V. CURRENT ISSUES

A. Congressional Concern about Nonprofits

In 2004 the Senate Finance Committee ("Committee") held hearings and announced its intent to investigate tax-exempt organizations. The Committee issued a draft white paper suggesting proposals for reform and establishing best practices for tax-exempt entities. Although the focus of the Committee's attention has been on issues most commonly found in public charities and private foundations,[4] IHE should be advised on the proposals under consideration[5].

Senator Charles Grassley, chairman of the Committee, is targeting a March 2005 introduction of various items into a new and improved CARE Act. Much of what Senator Grassley wants to add to the previously defeated CARE Act ideas are

[4] Examples being donor advised funds, family foundations, and director compensation.
[5] Private institutions and foundations supporting public institutions would be affected. Additionally, public institutions should be aware of the governance trends and implications.

found in the discussion draft that was circulated by the Senate Finance Committee in the summer.[6] Senate discussion draft proposed the following changes:

(1.) A mandatory five year review of tax-exempt status.

(2.) Tightening up the rules regarding donor advised funds.

(3.) Increasing penalty taxes for self-dealing.

(4.) Reducing or eliminating private foundation trustee compensation.

(5.) Expanding the definition of disqualified person and tying the compensation of disqualified persons to government compensation rates.

(6.) Limiting the extent to which administrative expenses can be treated as private foundation qualifying distributions.

(7.) Enhancing disclosure and independent audit requirements including CEO certification.

(8.) Federalizing rules governing nonprofit corporations, including director compensation and duties of care and loyalty.

(9.) Permitting an independent right of action for directors for claims not pursued in bad faith.

(10.) Permitting and encouraging greater communication and collaboration including enforcement between the Internal Revenue Service and the states.

At the request of the Committee, the Independent Sector, a Washington, D.C. based coalition of nonprofit entities, convened a Panel on the Nonprofit Sector ("Panel"). The Panel is comprised of nonprofit leaders from around the country. The panel created five work groups to address issues of governance, ethical conduct and accountability within the nonprofit sector. The Panel will submit an interim report to the Committee in March.[7]

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[6] www.cof.org/government - see *Senate Finance Committee Discussion Draft*

[7] www.nonprofitpanel.org

B. Reasonable Compensation

On August 10, 2004 the Internal Revenue Service announced an investigation to identify and address abuses by tax-exempt organizations that pay excessive compensation and benefits. [8] The Internal Revenue Service indicates that it will contact nearly 2,000 tax-exempt charities and foundations seeking additional information regarding their compensation practices and procedures. The investigation is part of a larger tax-exempt compensation enforcement project.

The Internal Revenue Service has indicated that through this project it intends to accomplish the following:

(1.) To address the compensation of specific individuals or instances of questionable compensation practices.

(2.) To increase awareness of tax issues as organizations set compensation in the future.

(3.) To learn more about the practices that organizations follow in setting compensation and how they report said compensation to the Internal Revenue Service and the public on their annual tax return.

Particular areas of focus will include compensation of specific nonprofit officers and insider transactions (such as loans and exchange properties). The announcement identifies a special interest in Form 990 reporting by charities, particularly with respect to how organizations answer the question 89 (b) "Did the organization engage in any excess benefits transaction during the year?"

The issue of executive compensation is not exclusive to the charitable world, however. Many presidents of colleges and universities received salaries that could cause the Internal Revenue Service to develop an interest in the compensation practices of the institution. [9] It is recommended that the boards of trustees of universities, when establishing compensation for their university president, follow

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[8] IR 2004-106.

[9] The Chronicle of Higher Education - October, 2004

the standards set forth by the Internal Revenue Code § 4958. Section 4958 and the regulations thereunder establish a process commonly phrased 'the rebuttable presumption.' The regulations contain a procedure or a process for establishing reasonable compensation. The process, as prescribed, assists in demonstrating that individuals did not receive excessive compensation. The procedure is called 'creating a rebuttable presumption of reasonableness.'[10]

Section 4958 states that the process for establishing reasonable compensation should cover 'disqualified persons'. Typically these persons are the officers and directors of the organization. The procedure should include the following:

(1.) An independent committee of the board of directors.

(2.) Comparability data. Comparability data may be based on industry service, documented compensation of persons holding similar positions in similar organizations, expert compensation studies or other comparability data. [11]

(3.) The decision-making body must document the basis for its determination concurrently with the approval. The documentation should include the terms of the approved transaction, the members of the decision-making body who were present, the comparability data that was relied upon and any conflicts of interests that were present.

On October 1, 2004 Leonard J. Henzke, Jr., a tax law specialist in the IRS Exempt Organizations Division addressed the employee benefits committee of the American Bar Association Taxation Section. Mr. Henzke focused on the issues surrounding the reasonableness of compensation arrangements. He commented that the executives whose compensation is being studied should not supervise or be involved in the production of the compensation report. Mr. Henzke also commented that the compensation report should consider comparable compensation packages of nonprofit agencies – comparables from for-profit

[10] IRC §4958

[11] The use of comparability data, including for profit comparability data, is a critical component in establishing the salary for university presidents.

organizations may be considered, but there must be nonprofits in the mix. Mr. Henzke suggested that the following be included as part of a compensation study[12]:

(1.) A complete list of the names of each compared organization.

(2.) Identification of the organizations as for-profit or tax-exempt.

(3.) The annual revenues of each compared organization.

(4.) The number of employees of each organization.

(5.) The standard industry code of each for-profit organization.

(6.) The National Taxonomy of each exempt entities code for each exempt organization.

(7.) A breakdown of the compensation package of each executive in each compared organization including current salary, annual incentive compensation, bonuses, differed compensation, long-term incentive compensation, the value of fringe benefits, pension benefits, supplemental retirement benefits, severance compensation, the value of stock options and consulting fees received.[13]

In a recent technical advice memorandum, the IRS discussed whether a not-for-profit organization had met the intermediate sanctions standard for rebuttable presumption that the compensation was reasonable. The significance of the technical advice memorandum is that it reiterates the three standards of the rebuttable presumption. First that the compensation was reviewed by an independent committee that was independent of the transaction, second that the committee adequately documented their deliberations and third, that the committee utilized appropriate comparability data to indicate that the compensation was comparable to persons in similar positions[14].

[12] See Sept. 15, 2004 letter of ABA Section of Taxation to Senate Finance Committee.
[13] Tax Analyst - 2004 TNT192-11.
[14] See TAM200244028.

C. Updated Form 1023

On November 1, 2004, the Internal Revenue Service issued a revised application for exemption from federal income tax under Code Section 501 (c) (3) ("Form 1023"). The revised application reflects many of the emerging trends in the realm of corporate governance – including a recommended form of conflict of interests policy and questions for organizations that do not adopt a conflict of interests policy and an emphasis on practices to follow when setting compensation levels.

The IRS expressed several reasons for revising the Form 1023, including changes in the tax laws, reducing the time required to process Form 1023, making the instructions easier to understand and detecting organizations that abuse the tax-exempt status and erode public confidence in the nonprofit sector.

The new Form 1023 includes additional detail on the following:

(1.) Who makes an organization's compensation decisions;
(2.) Whether comparable information is evaluated;
(3.) Whether contemporaneous records are kept regarding compensation decisions;
(4.) Whether payments are made to third parties who helped create the organization;
(5.) Whether payments are made to directors, trustees, or officers;
(6.) Names and addresses of the organization's five highest-paid employees and independent contractors who earn more than $50,000 annually (including a justification of their compensation);
(7.) Any relationships the organization may have with employees' businesses and family members; and
(8.) Conflict-of-interest policies adopted by the organization (such policies are recommended by the IRS).

Further, the application process queries the entity's use of donor advised funds, whether it has foreign operations, vehicle donation programs and conservation easements.

D. Compliance and Ethics Programs

On November 1, 2004, amendments to the Federal Sentencing Guidelines for Organizations became effective, which among other things highlighted the responsibility of boards of directors to oversee corporate compliance and ethics programs. (These provisions stem from the Sarbanes-Oxley Act of 2002.) The amended Federal Sentencing Guidelines mandate significant board involvement in ethics and compliance programs in order to mitigate potential criminal penalties. Boards must be aware of existing systems and participate in the designs and maintenance of new ones.

The history of the Sentencing Guidelines is that a corporation can be held liable for an employee's criminal act if that act is within the apparent scope of the individual's employment even if the act is contrary to corporate policy and instruction. The guidelines direct the court, in determining the corporation's culpability, to consider aggravating factors that may increase the ultimate punishment to the corporation. The amended guidelines establish two mitigating factors that a court consider which may lessen the severity of a penalty imposed reducing potential fines by as much as 95%. The existence of an effective compliance and ethics program is one such guideline.

A corporation should demonstrate that it exercises due diligence to prevent and detect criminal conduct and that it promotes an organizational culture that encourages ethical conduct and commitment to the compliance with law. The amended guidelines provide seven requirements to satisfy this standard.

(1.) Standards and procedures are established to prevent and detect violations of law. The board should direct management and legal counsel to review the corporation's code of conduct to assess in particular whether the standards and procedures adequately address the areas that pose the most significant risk of unlawful and unethical behavior. Management should discuss those issues with the board.

(2.) Directors and senior management are engaged in the design, implementation and maintenance of compliance and ethics programs. The board should review the adequacy of the authority delegated and the resources provided to the personnel charged with operational responsibility for compliance and ethics. The senior manager should report directly to the board at least annually, as should the personnel with day-to-day operational responsibility.

(3.) Management personnel are screened for past illegal or unethical conduct. The board should review with senior management the screening methods used and the positions of authority throughout the corporation to which such screenings should apply.

(4.) Compliance and Ethics training is required and undertaken at all levels. The board should review with management plans for periodic compliance and ethics training sessions for all corporate personnel as well as other means of communicating compliance and ethics standards throughout the corporation.

(5.) Efforts should be made to encourage and monitor compliance with and to evaluate the effectiveness of the compliance and ethics program. The board should review with management the avenues of communication available to all corporate personnel for anonymous reporting of concerns about actual and potential violations of law and ethics.

(6.) Incentives and disciplines are used to promote compliance. The board should review with management the sanctions for misconduct that are incorporated into the compliance and ethics program.

(7.) The corporation responds appropriately if and when criminal conduct occurs. The board should discuss with management the creation of procedures to ensure the prompt and appropriate response to specific violations.

The amendments to the Federal Sentencing Guidelines place responsibility on boards to ensure that management has instilled an appropriate organizational culture and instituted effective compliance and ethics programs. The construct is that where disciplined organizational culture is present, adherence to legal and ethic standards will follow.[15]

VI CONCLUSION

The current governance climate is one of suspicion. The public’s trust in governance structures has eroded. While arguably some of this erosion is well founded as demonstrated by the media coverage of abuses, much of the lack of trust is unfounded. Irrespective of the justification for suspicion, IHE and nonprofits are challenged to seize the opportunity to become more transparent. Governance needs to be above reproach. It is critical that Boards voluntarily hold themselves to the highest standards of ethical conduct. Boards need to voluntarily adopt SOA as a best practice, focus on compensation practices and pay attention to compliance programs. These efforts will establish good governance practices that create a culture of excellence.

[15] See NACD Directors Monthly – September 2004

APPENDIX A: CONFLICT OF INTEREST

STETSON UNIVERSITY COLLEGE OF LAW

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Re-emerging Concern for Conflicts of Interest and Commitments: Practical Considerations for Policy Development

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I. The cicada-like re-emergence of concern for conflict of interest can be traced, in part, to the recent corporate scandals. Enron, Tyco, WorldCom, Adelphia and their ilk have prompted a resurgence of interest in corporate governance that includes examination of the adequacy of policies addressing conflict of interest and commitment.

The nonprofit sector has not been immune from conflict of interest issues. Several years ago, the national head of the United Way William Aramony's scandalous behavior brought disrepute to that organization, as well as a criminal conviction for him. A recent New York Times article, *Battle in an Omaha Charitable Group Reflects Issues Raised in Corporate Scandals* (NY Times National ed., 1/9/2004, pg. A11) focused attention on an intra-family dispute in which the Omaha foundation's patriarch alleged that some grants made by the foundation constituted conflicts of interest and self-dealing by his nephew, a trustee and a foundation manager. Other recent conflict of interest situations in the nonprofit world cited by the Times included the University of Georgia Foundation's spending more than $30 million in dealings with companies linked to 27 of its 55 trustees; a Minnesota court ordering changes in the board overseeing the distribution of Minnesota's tobacco settlement funds because many board members were representatives of organizations that were very likely to seek the funds; foundations linked to the New

York Stock Exchange and Nasdaq have been criticized for making donations to organizations with ties to their board members; and the Senate Finance Committee is investigating the Nature Conservancy, in part for its purchases of land from board members' companies and for below market sales of real estate to trustees. The Times observes "In the charitable world, the exploitation of personal connections has long been seen as more virtue than vice. But in the new climate, lawyers for charities say they have been flooded with requests for counsel on potential conflicts: Should a lawyer or an accountant whose firm is paid to work for a charity or foundation sit on the organization's board? Given the news media's increasing role in questioning nonprofit activity, should a newspaper publisher be on the board of any charity?"

Conflict of interest claims against university presidents and boards have arisen in recent years. In Oliver v. Boston University, 27 Del. J. Corp. L. 391 (Del. Ct. of Chancery 2000), a suit alleging conflict of interest, self dealing and breach of the duty of loyalty was brought against former Boston University President John Silber (and others) for their alleged corporate malfeasance. A proceeding to remove the trustees of Adelphi College for providing lavish compensation and benefits to Adelphi's president, engaging in conflict of interest transactions and failing to properly oversee the university continued, despite the university's attempts to dismiss it. Adelphi Univ. v. Bd. of Regents, 647 N.Y.S. 2d 678 (Sup. Ct. 1996). Later, the former board was ousted and replaced.

This is an age of accountability, with heightened concern for ethical behavior by board members, university administrators, faculty and others with decision-making authority. This paper will examine the process for developing policies of conflict of interest and commitment, and the component's of those policies.

II. Why Worry About Conflict of Interest?

We are well beyond the Alfred E. Newman of Mad magazine's "what, me worry" attitude when it comes to conflict of interest. An extensive delineation of all state and federal laws prohibiting conflict of interest is beyond the scope of this paper. Preventing conflicts and insuring that decisions are made on the basis of merit, not influence, by public officials underlie legislation in many states.

Perhaps inspired by numerous federal indictments of former employees of the Illinois Secretary of State's Office, including former Secretary of State (and former Governor) George Ryan, Illinois passed a major enhancement of its ethics legislation, Public Act 93-0617. Applicable to state universities as well as other state government employees, it mandates annual ethics training for all employees of state higher education institutions, including their boards. It limits eligibility for appointment to state boards by excluding, among other persons, lobbyists or their spouses. Limitations on employment of former state employees by businesses they contracted with are imposed, as are restrictions on gifts to state employees by those doing business, or seeking business, from state entities, including universities. Public Act 093-0617 (Ill. 2003)

Illinois statutes also contain the "University Faculty Research and Consulting Act" (110 ILCS 100) which seeks to address conflict of interest and conflict of commitment by requiring full-time faculty at any state higher education institution to obtain approval from the institution's chief executive (or designee) before undertaking any consulting services. In addition, the faculty member must submit an annual statement of "actual time" spent on outside research or consulting services.

Avoiding private inurement should be a concern for private colleges and universities. Should a conflict of interest constitute private inurement, income tax exempt status under section 501(c)(3) of the Internal Revenue Code could be jeopardized. Impermissible private inurement involves two elements: (1) the individual (insider) who receives the benefit has the ability to control or otherwise influence the actions of the tax-exempt organization so as to cause the benefit, and (2) the benefit conferred be intentionally conferred by the tax-exempt organization. An example of how a conflict of interest could constitute private inurement would be a situation where a director or officer of a nonprofit caused a financial benefit to be conferred that was not in the organization's best interest. For more on private inurement, see Bruce R. Hopkins, The Law of Tax-Exempt Organizations, (6th ed. 1992).

Recipients of research grants from the National Institution of Health and the National Science Foundation have long been subject to conflict of interest policies. Other federal agencies, however, do not have financial conflict of interest standards for university research grants, according to a recent GAO study, University Research: Most Federal Agencies Need to Better Protect Against Financial Conflicts of Interest (GAO-04-31, 2003). The GAO report urges the development of conflicts policies by the other funding agencies. Thus, one can anticipate an ongoing necessity to develop and revise conflict of interest policies.

Conflicts of interest in clinical research have been a significant issue for some time for health science centers with research supported by federal funds. A valid concern exists that financial relationships could cause a faculty member to prefer an outcome congruent with his or her financial interest, with a concurrent maximization of risk to a patient, and exaggeration of benefit. Concern exists that a significant financial interest could influence the design, conduct or reporting of PHS-funded research and that equity interests held by institutions could affect the outcome of research, all to the detriment of the patients involved in the study.

Federal guidelines mandate a process of disclosure and review by institutional review bodies with participation denied for researchers with a significant financial interest in the outcome of the research. The consensus of observers of the process of conflict of interest resolution is that more rigorous guidelines will issue from governmental funding entities and that there will be increased scrutiny of situations that involve conflicts of interest, or the appearance thereof. The inescapable conclusion is that if we don't police ourselves, the government will.

III. Conflict of Interest and Commitment Policy Development

A. When Does It Occur?

Policy review, revision and development is typically initiated in higher education for one or more of the following reasons:

1. A change in relevant statutes or regulations;
2. A judicial decision;
3. The appointment of an administrator;
4. An unfortunate incident;
5. Direction from above;
6. Comparison with policies at other institutions;
7. Passage of time;
8. “Best practice” implementation;
9. Faculty initiative;
10. Government review or complaint resolution;

B. Who Does It?

“Does” has two components, the drafting, and review or consultation. The administrator of the institution’s office dealing with grants, contracts, technology transfer and human subjects should be a key figure in the drafting process. Probably several people from that office, along with legal counsel, will produce the initial draft. Other administrators or a few faculty may be involved. But the drafting group should always be small in number, in order for the project to proceed at a reasonable pace.

At institutions with faculty unions, one will have to consider whether the policy must be bargained. Hopefully, this will normally not occur. Institutions with unions should exclude issues of legal compliance from the scope of bargaining. Legal compliance is an institutional responsibility. The impact of non-compliance will normally have a more significant effect on the institution, such as loss of funding, than the individual faculty member or union.

Obviously, consultation with university constituencies affected by the policy needs to occur to assure voluntary participation and compliance. But extensive redrafting should be discouraged. At this stage, the role of the key administrators involved in the drafting shifts from drafting to advocacy and explanation.

C. Who Is Covered?

Those encompassed by the policy, at the very least, should be the faculty and staff within the scope of federal or state regulation. It would be desirable to construct a policy that goes beyond the current state of regulation. Faculty and professional staff are the groups most commonly covered by a policy. Groups within the university, like purchasing officers or university counsel, may create additional policies, such as prohibiting acceptance of gifts from vendors or limiting outside legal practice.

Trustees of private universities often have separate policies. Often statutory prohibitions constitute the policy for trustees of public institutions.

D. What Is Covered?

Regulation or prohibition of activities or relationships that create conflicts of interest or conflicts of commitment are the objectives of the policies. A clear definition of the conflicts, and a general understanding of what may constitute a conflict by those governed by the policy, are essential initial conditions for an effective policy.

Definitions vary: See the SIUC policy following for examples. Another example: "*A conflict of interest exists when an individual has an external economic interest that affects or provides an incentive to affect the individual's conduct of his or her university activities. Conflicts of interest can arise naturally from an individual's engagement with the world outside the university. The mere* *existence of a conflict of interest does not necessarily imply wrongdoing on anyone's part. When conflicts of interest do arise, however, they must be disclosed and either eliminated or managed."* Excerpt from SIU School of Medicine Policy.

A conflict of commitment definition proposed by the Association of American Medical Colleges follows: *"The term conflict of commitment relates to an individual faculty member's distribution of effort between obligations to one's academic appointment…and one's commitment to "outside" activities…. A conflict of commitment arises when these [outside] or professionally removed activities (e.g., outside teaching or business) come to interfere with the paramount obligations to students, colleagues, and the primary missions of the academic institution by which one is appointed and salaried…."*
Guidelines for Dealing with Faculty Conflicts of Commitment and Conflicts of Interest in Research, 65 ACAD. MED. 487, 490-91 (1990)

Some policies include examples of conduct that would be regulated or prohibited. So long as they are understood to be examples only, and not limitations on the institution in similar cases, they probably are useful. Because conflict of interest usually has a financial component, a definition of what constitutes a significant or substantial financial interest is essential.

E. The Necessity of Disclosure

Disclosure of a conflict of interest before the transaction, whatever it might be, is completed, or approved, is essential. Many institutions require annual reporting. However, "after the fact" reporting, in addition to not heading off conflicts, creates a more difficult situation for administrators to resolve. If a conflict of interest already exists, potential liability may exist for the individual and the institution. The administrator discovering the conflict will undoubtedly incur the enmity of the person with the conflict because the conflict situation will probably be terminated. Annual reporting may be somewhat useful in detecting and managing conflicts of commitment. Inquiry can be made to determine whether the faculty or staff member will be able to meet his or her institutional responsibilities and a monitoring plan can be developed. Many outside activities can be beneficial to the institution, such as participation in professional organizations, but clearance for extensive involvement should occur in advance.

Prior disclosure of potential conflicts of interest is critical. A comprehensive requirement for disclosure and approval of any outside activity, including contracts for research, for which the faculty or staff member receives compensation, or has a significant financial interest, will serve the institution well.

F. Review of Disclosures

Most institutions already have procedures in place to review disclosures and assess conflicts. A number of institutions have appointed ethics officers, often an additional responsibility for the institution's general counsel. The ethics officer's duties can include reviewing disclosures and addressing individual conflict of interest questions. In addition, that person should keep the campus community informed of statutory and regulatory developments.

Because of the emphasis by government and the media on conflict of interest issues in clinical research, many institutional review boards have resolved conflict issues involving researchers with ties to drug or device companies. Some institutions have created bodies to address conflict of interest issues. Another approach is to have the issue brought to the immediate superior (e.g., Dean) or some other administrator.

Conflict of commitment issues can best be resolved between the faculty or staff member and his or her supervisor, in consultation with the next level of review (e.g., Department Chair and Dean). The Department Chair will (or should) be aware of the time demands and university responsibilities relevant to an assessment of a potential (or actual) conflict of commitment. Involving the next level of supervision should assure uniformity of approach.

Whatever process is chosen for examining and resolving conflicts of interest, care must be taken to assure consistency. Probably the only way to assure this is to have, within the university, a person who will be aware of the resolutions and will be a resource for those making them, if decision-making occurs by others. Faculty and staff will normally be reluctant to disclose potential conflicts so the process needs to reassure them that they are not being penalized for seeking guidance or making a disclosure.