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The Responsibility and Accountability of Governing Boards: Recent Developments

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I. INTRODUCTION

While it appears that the torrent of for-profit corporate malfeasance, misfeasance and nonfeasance witnessed earlier in this decade has abated, recently the non-profit sector has provided several examples of governance and fiduciary responsibility failures. Most prominent has been the American University/Ladner debacle. As this paper was being prepared, *The New York Times* of December 30, 2005 described two more problematic situations.

On page one, the caption read, “U.S. To Monitor Medical School In New Jersey.” The lead on page A-24 was “U.S. To Monitor Big Medical School After New Jersey Fraud Accusations.” According to the U.S. Attorney for New Jersey, the University of Medicine and Dentistry of New Jersey had defrauded the federal and state governments in a scheme that involved “the purposeful over-billing of Medicaid.” He further stated that senior administrators at the University had, for years, been aware of the fraudulent billing. Indeed, an outside law firm hired to examine the billing issues confirmed that double billing was going on and urged the University to take appropriate remedial action.

Taking action unprecedented for higher education, the U.S. Attorney appointed a "monitor" to oversee financial matters at the school.

The monitor, a former U.S. Attorney, will report to the U. S. Attorney and be significantly involved in the financial affairs of the institution, and has the authority to make recommendations to the board concerning the retention of senior management. Already, the University's general counsel and two compliance officers were forced to resign. Whether the President, a former Chair of the University's Board of Trustees, can avoid termination remains to be seen. The article did not indicate that trustees were being removed yet, Indictments of several University officials are anticipated.

Since the national United Way, following the Aramony scandal, apparently has reformed, our current contender for the title of America's largest dysfunctional charity is the Red Cross. Inadequacies in its response to Katrina, coupled with its mishandling of 9/11 donations, have turned the reform spotlight on the Red Cross. On December 30th, *The New York Times* reported that "Senators Press Red Cross For A Full Accounting: Questions Are Raised About Governance." (Page A12). The story began "The Senate Finance Committee began an inquiry into the American Red Cross . . . seeking a broad range of information about its governance, its handling of money donated for disaster relief and its compensation policies."

The Red Cross is chartered by Congress and has the responsibility for structural reform. Finance Committee Chair, Charles Grassley criticized the size of the Board (50). Thirty (30) seats on the Board are allocated to the Red Cross Chapters, and the U.S. President appoints eight. The Board elects the remaining 12. Questions by the Finance Committee were also raised concerning the extent of the organization's former chief executive's salary, $468,599.00 per year.

The Senate Finance Committee has also sent an extensive inquiry to American University in the wake of the Ladner debacle. (See Appendix A.) Such a sordid situation, extensively reported the *The Washington Post*, will undoubtedly spur Congressional initiatives.

A *Chronicle of Philanthropy Profile* (June 9, 2005, pgs. 35-38) of Dean A. Zerbe, the Finance Committee aide leading the review of non-profits, reveled that Zerbe ". . .hopes to put in place new rules that would force charities to disclose more information about their operations and help determine whether certain groups deserve to keep their tax exemptions. He also aims to help speed through legislation this year designed to end specific non-profit legal abuses he has found in his investigations." (*Chronicle*, page 36). At the time of the preparation of this outline, the anticipated legislation had not been introduced.

II. RESPONSIBILITIES OF DIRECTORS AND TRUSTEES

The board of directors is responsible for directing and managing the affairs of the non-profit 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.

III. STANDARDS OF CONDUCT FOR DIRECTORS AND TRUSTEES

1. Evolution from trust to “business” or “best” judgment standard;
2. The trust standard made the trustees potentially liable for ordinary negligence, limited delegation of responsibility and prohibited transactions between the trustee and the entity.

   a. The “Sibley Hospital” case provided impetus to the adoption of the “business” or “best” judgment standard. The court declined to apply the trust standard and applied the less stringent corporate standard of case, which requires directors of non-profit 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 Non-Profit Corporation Act, codified the standards derived from “Sibley”:

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

   i) in good faith;

   ii) with the care an ordinary prudent person in line position would exercise under similar circumstances; and

   iii) in a manner the director reasonably believes to be in the best interest of the corporation.”

   The “standards” provision specifically states “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 non-profit corporations must fulfill the duties of care, loyalty and obedience.

3. Duty of care: The responsibility to act in good faith, as a prudent person and in the best interest to the entity includes:

   a. Regular attendance at board and committee meetings

b. Exercising independent judgment

c. Assuring the timeliness, adequacy and clarity of information

d. Reasonable reliance on information provided by persons regarded as credible

e. Adopting appropriate monitoring and control procedures

f. Documenting delegation of authority to officers

g. Avoiding engaging in the non-profit's day-to-day operations

h. Careful examination of financial statements

i. Insuring adequate discussion of significant matters

j. Avoiding "rubber stamping" the recommendations of management without necessary inquiry.

For a useful discussion of the duty of care, and other board member responsibilities, see the ABA's Guidebook for Directors of Non-Profit Corporations (2nd Ed. 2002).

4. Duty of Loyalty

a. Standard: A board member shall act in the interest of the corporation, and not in their own interest or that of another person or entity

b. Implementing the Duty of Loyalty:

i) Avoid using the position for personal and financial gain.

ii) Avoid conflicts of interest, self-dealing and private inurement.

iii) Have an effective conflict of interest policy that requires advance disclosure of interests and recusal from deliberations on the transaction by the interested director.

iv) Maintain confidentiality of the non-profit's information until appropriate for public disclosure.

c. Private Inurement

i) Section 501 (c) (3) of the Internal Revenue Code requires that no part of the net earnings of the tax-exempt organization inure to the benefit of any individual. This prohibition precludes the revenues of resources of the tax-exempt organization from being transferred to any director, officer or employee except as reasonable payment for services rendered or goods supplied. The IRS has stated that "[I]nurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purposes" and "[t]he inurement prohibition services to prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use." IRS General Counsel Memoranda 38459 and 39862.

ii) Excess Benefit Transactions: In 1996, Section 4958 was added to the Internal Revenue Code. It addresses the issue of excess benefits afforded to employees of non-profits by imposing financial sanctions on individuals and the boards providing them.

5. Conflict of Interest

a. A perception that directors and officers of a non-profit are using their position to enhance their personal or financial interests will be destructive to the credibility of the organization and its fund-raising activities.

b. While disclosure of a conflict of interest and approval of the transaction by the directors who do not have a conflict, providing they determine that the transaction is fair, is legally sufficient for the boards of most non-profits (see Section 8.32, Director Conflict of Interest, Revised Model Non-Profit Corporation Act), most public bodies and an increasing number of non-profits prohibit transactions between the entity and its boards members.

c. Increased IRS scrutiny of conflict of interest issues was signaled by the addition of questions about the existence of a conflict of interest policy (you need one) to IRS Form 1023, the form used to seek 501 (c) (3) status.

d. Cases providing examples of the bad publicity and financial liability that can occur when directors and trustees ignore their duty of loyalty and seek to profit to the detriment of their non-profit include:

- *Adelphi University v. Board of Regents*, 647 N.Y.S. 2d 678 (Sup. 1996); *The Committee to Save Adelphi v Diamandopoulos*, Board of Regents of the University of the State of New York (1997) www.nysed.gov/regents/docum.html

  The Board of Regents successfully blocked the Adelphi Board's efforts to derail an investigation of a number of questionable practices, including lavish compensation, conflict of interest, self-dealing and other neglect of duty. The Regents' investigation confirmed the validity of many of the allegations and they ordered the removal of Adelphi's trustees.

- *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 purported charity and to obtain reimbursement for funds expended on their behalf. 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 non-profit's funds; installing a phone in every room in a director's home; and attempting to conceal improper personal purchases.

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

- For a comprehensive discussion of the "corporate opportunity" doctrine, an element of conflict of interest, see *Northeast Harbor Golf Club v. Harris*, 725 A.2d 1018 (Me. 1999).

IV. PANEL ON THE NON-PROFIT SECTOR

In response to an invitation from Congress (The Senate Finance Committee, specifically), leaders of major non-profit organizations convened a diverse and extensive group of non-profit leaders and government officials to address issues of transparency, governance and accountability. The group's report, (sometimes termed The Independent Sector Report), issued in June 2005, contained the following proposals, among others:

1. Disclosure

a. Non-profit groups should be required to:

i) Ensure that their informational tax returns are signed by their chief executive officer or another top official.

ii) Get a financial audit if they have $2 million or more in total annual revenue.

iii) Hire an independent public accountant to review their finances if they have $500,000 to $2 million in annual revenue.

b. The Internal Revenue Service should:

i) Require all charities to disclose on their information returns whether they have a conflict of interest policy.

ii) Suspend the tax-exempt status of organizations that fail to follow federal requirements for disclosing information to the IRS for two or more consecutive years.

iii) Fully enforce penalties on organizations that do not file complete or accurate returns.

2. Governance

a. Non-profit groups should:

i) Adopt and enforce a conflict-of-interest policy.

ii) Include on their boards, people who demonstrate financial literacy and consider establishing a separate board committee to oversee audits of the organization.

iii) Establish policies and procedures to encourage whistleblowers to come forward if they know about violations of the law or an organization’s policies.

3. Preventing Legal Abuses

a. Congress or the Internal Revenue Service should:

i) Impose fines on accountants and others who prepare non-profit returns if they omit information or misrepresent facts or figures.

ii) Increase the penalty fees that must be paid by foundation managers and other "insiders" who participate in self-dealing transactions.

iii) Modify the standards for imposing penalties on non-profit managers who abuse the law to make it more likely the IRS will punish wrongdoers.

iv) Pass laws and penalties to punish charities that participate in illegal tax shelters.

v) Increase the amount of money the federal government spends to enforce charity rules.

vi) Encourage states to adopt the same standards the federal government uses to monitor and penalize charities.

vii) Allow state officials to gain access to IRS information on charitable organizations.

See *Chronicle of Philanthropy*, 3/17/05, pg 31.

b. IRS scrutiny of donor advised funds will increase, according to Internal Revenue Commissioner Mark W. Everson, who delineated abuses by those funds in a letter to the senate Finance Committee in April, 2005. See Washingtonpost.com April 5, 2005, pg. E01.

4. Board Size

The report endorses the generally accepted minimum of three (3) persons but rejects any upper limit (the Senate Finance Committee had suggested fifteen [15]). To qualify for public charity status, at least one-third (1/3) of the board members should be independent. An "Independent" board member is one who has not received compensation or material benefits from the non-profit in the last 12 months, and who is not related to someone receiving compensation or material benefit from the non-profit.

The report's position probably reflects the reality that many non-profits, especially private universities, have large governing boards. The members of such boards often have limited roles in governance but are relied upon for significant financial support.

V. THE CONTINUING IMPACT OF SARBANES-OXLEY

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].

[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:

With the exception of two provisions of SOA, the act does not apply to governance procedures for non-profit 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 non-profit entities. What follows is an over-view of first, those provisions of SOA that all entities, including non-profits, must follow and second, an analysis of best practices concerning the provisions of Sarbanes-Oxley and their applicability to non-profits.

1. **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. Non-profits should begin by developing procedures for handling employee complaints. A non-profit should have a confidential and anonymous mechanism to encourage employees to report any financial management

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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.

inappropriateness. Even if claims are unfounded, the non-profit 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 non-profit organizations deals with document destruction. It is prudent that a non-profit 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, non-profits should stop any document purging in order to avoid criminal obstruction charges.

2. 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.

a. 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 non-profits 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.

b. 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 non-profits.

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 non-profit. 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.

c. 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.

d. Insider Transactions and Conflicts of Interests

The SOA generally prohibits loans to any directors or executives of a company. Loans to non-profit executives have received heightened attention by the media. It is prudent that non-profit 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.

e. 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 non-profits should feel compelled to provide donors, clients, public officials, media and others with an accurate picture of their financial condition.[2]

3. What does SOA REALLY mean to the IHE?

Many boards of IHE bristle at mention of SOA. Board members are not paid to serve on the board, board members serve out of commitment to the institution and its educational vision and mission. The argument is that SOA is for public companies and those boards don't serve with a true love of the institution. But, what is the harm in boards of IHE choosing to be more SOA compliant? Clearly, much of SOA is not applicable to IHE. But, there is value in boards giving thoughtful consideration to voluntarily adopting some of SOA.

The public debate on higher education is demanding more transparency. The impression that higher education operates in a realm of secrecy not open to the public and its scrutiny could undermine perceptions of institutions and the system of higher education. Arguably it would be harmful to IHE for the public to believe publicly traded companies adhered to higher standards than IHE. Each institution should assess what makes sense for its governance, being mindful of the heightened scrutiny being placed on higher education in the public debate.

[2] See Society for Nonprofit Organizations January 2003 / February 2003 Vol. 21, no. 1, page 6.

VI. ISSUES FOR DISCUSSION/THOUGHT

A. How are Board Members Selected?

1. Can public institutions influence the selection process?
2. Term limits?

B. Is there an Optimal Board Size?

1. Executive committee responsibilities
2. Committee credibility vs. committee of the whole?

C. Board Member Orientation: Adequacy?

D. Access to Information

1. How much and when?
2. Ability to contact staff

E. Is “Deference” to the Chief Executive often an Abrogation of Fiduciary Responsibility?

F. Are your Conflict of Interest/Conflict of Commitment Policies adequate?

1. Can you maintain community credibility when board members provide compensated services?
2. Can a lawyer/board member effectively represent the non-profit?

G. Should Size/Resources of a Non-Profit Determine the Extent of Transparency, Governance and Accountability Requirements?

H. What will the Senate Finance Committee and Congress do in 2006 to Impact Charitable Organizations?