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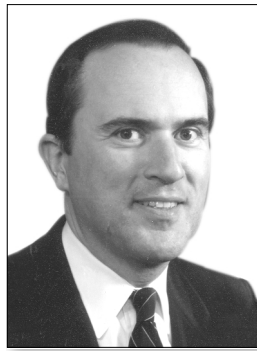
HEALTH LAW

BY FRANCIS J. SERBAROLI

Sarbanes-Oxley and Corporate Governance of Non-Profits

THE NEW EMPHASIS on corporate accountability prompted by fiascos as varied as Enron, Global Crossing and WorldCom has brought into being the much-discussed Sarbanes-Oxley law. Meanwhile, the world of charities and not-for-profits has had its own share of notable fiascos, including the United Way scandals, the collapse of the Allegheny Health Education and Research Foundation System, the recent allegations of improprieties involving Health MidWest and Allina Health System, and the controversies over several conversions of nonprofit Blue Cross plans, to name but a few.

The unseemly activities that occurred in some of these ostensibly charitable not-for-profit organizations have highlighted the need for greater accountability and disclosure on the part of nonprofits generally and nonprofit health care organizations in particular. Thus, although Sarbanes-Oxley does not apply specifically to not-for-profit corporations, spillover effects from the new law are now being felt as the governing boards of nonprofits, many of which include corporate executives already steeped in Sarbanes-Oxley's requirements, struggle to graft



the law's corporate reforms onto their own organizational structures.

Problems

In the overwhelming majority of cases, the boards of nonprofit organizations consist of dedicated individuals who volunteer their time, talents and energies, fulfill their board duties responsibly and work hard to advance the missions of their organizations. But in many other cases, boards have serious problems: they are not governing effectively, not holding their top executives accountable, not monitoring the organization's operations and performance standards and not being responsive to the communities or constituencies supposedly being served by the organization. In the worst cases, the boards of some nonprofits can be rife with neglect, incompetence, conflicts-of-interest, self-dealing and misuse of assets.

Governing board members who are not fulfilling their responsibilities are

not only failing in their duties to their organization and particularly to those served by their organization, but they may also be jeopardizing the organization's reputation and even its very existence. They are also exposing themselves to potential individual liability. Accordingly, a growing number of nonprofit boards are starting voluntarily to implement some Sarbanes-Oxley reforms in their corporate governance structures and internal compliance programs. They are undertaking these steps for a number of reasons:

- Many of these organizations will soon experience the heightened scrutiny of their operations and governance by government and the media.
- Because "an ounce of prevention is worth a pound of cure," an investment in better internal controls will pay significant dividends in problems and costs that are avoided.
- These measures are not just about complying with mandates, but will actually benefit these organizations and improve their functions and effectiveness.
- It's better to stay a step ahead of aggressive regulators.

Some "good governance" practices are already finding their way into federal regulations. For example, the General Accounting Office (GAO) has issued regulations that apply to nonprofits that receive more than \$300,000 in federal funds. (This group includes virtually all health care

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providers, since they receive significant Medicare reimbursement.) Among other things, the GAO regulations deal with nonaudit or consulting services provided by the organization's outside auditing firm. They set forth independence standards prohibiting auditors from performing management functions or making management decisions and further prohibiting auditors from auditing their own work or providing consulting services in areas that are material to the subject matter of the audit.

The Internal Revenue Service is studying whether tax-exempt organizations should be required to disclose such matters as the degree of a board audit committee's independence; any transactions between the organization and its trustees/directors, officers, senior executives or contributors; the organization's conflict of interest policies; and other information bearing upon the organization's integrity. The IRS is also considering whether to mandate new disclosures on the IRS Form 990, which most charitable organizations are required to file. And last year, the IRS' intermediate sanctions regulations laid out clear guidance to nonprofits regarding executive compensation criteria. Meanwhile, here in New York, Attorney General Eliot Spitzer has proposed a comprehensive bill that would apply many of Sarbanes-Oxley's most significant provisions to not-for-profit organizations.

Self-Evaluation

In deciding whether to implement Sarbanes-Oxley reforms, the first step is for the board of a nonprofit to do a thoroughly honest and comprehensive self-evaluation of its own governance structures and effectiveness, including a review of the organization's internal controls and compliance mechanisms. Board scrutiny should focus on the

areas of finances and financial controls, executive compensation and the adequacy of policies and procedures for avoiding board and executive conflicts of interest.

Adopting some Sarbanes-Oxley requirements is advisable for most nonprofit organizations. Moreover, though not currently mandated by law, these and other requirements may ultimately be forced upon nonprofits by state law, state regulators, court decisions, Internal Revenue Service requirements, bond underwriting requirements or other mandates.

Here are some of the specific steps

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that some major not-for-profit organizations are taking in order to stay ahead of the curve.

Audit Committee

Traditionally, nonprofit boards have had a finance committee that handled all significant matters related to the business side of the organization and made recommendations to the full board. Such a committee would initially review and approve the operating and capital budgets, formulate financial policies, prepare long range financial plans, monitor the organization's financial activities and transactions, retain and supervise the independent auditor and even oversee internal compliance programs.

Sarbanes-Oxley's requirement of an independent audit committee has been adopted by many non-profits.

The model for this audit committee calls for it to consist entirely of board members who are not executives or otherwise employees of the organization. The audit committee's responsibilities include consulting and working closely with the organization's independent auditors, as well as establishing and monitoring internal financial controls, including procedures for handling whistle-blower complaints about irregularities. If an audit committee does not already exist, the corporate bylaws will probably need to be amended so as to create a permanent committee and define its responsibilities. One or more members of the audit committee must have financial expertise, and no member of the audit committee should have any paid business, financial or consulting relationship of any kind with the organization outside of his or her service as a director. If an audit committee already exists, it may need to be restructured (and the corporate bylaws amended) to incorporate these responsibilities and restrictions.

Financial Statements

More controversial is Sarbanes-Oxley's requirement that both the chief executive officer and the chief financial officer personally attest to the validity of the organization's financial statements and internal controls. Under the law, both officers must verify that:

- they have reviewed the financial statements,
- the statements do not contain "any untrue statement of a material fact" or a material omission,
- the statements fairly present the organization's financial condition,
- the chief executive and the chief financial officer have designed and evaluated systems of internal controls to ensure that they are aware of

material information concerning the organization's operations, and

- the chief executive and chief financial officer have disclosed to the board's audit committee and to the independent auditors all deficiencies in controls and any fraud involving management and key employees.

Currently, the chief financial officer of a nonprofit healthcare provider such as a hospital must certify the institution's Medicare cost reports; and, if the organization is tax-exempt and is required to file a Form 990 with the Internal Revenue Service, that form must be verified by an officer who can vouch for the accuracy of its contents. Therefore, implementation of these new certification requirements by nonprofit health care providers considerably extends these reporting requirements, placing both the chief executive as well as the chief financial officer in a position of personally verifying the accuracy and completeness of the organization's financial statements, and the adequacy of its internal financial controls.

Loans

Sarbanes-Oxley prohibits most personal loans from a corporation to its directors or senior executives. New York law already prohibits loans by any not-for-profit corporation to its directors or officers, or to any corporation, firm, association or other entity in which one or more of its directors or officers are directors or officers, or hold a substantial financial interest. NY Not-for-Profit Corporation Law, §716. Nevertheless, any loans by any not-for-profit corporation (e.g., a loan by a hospital to one of its physicians) should be carefully scrutinized by the board's audit committee and reviewed for compliance with all applicable laws.

Code of Ethics

Sarbanes-Oxley requires all publicly traded corporations to disclose whether or not they have adopted a code of ethics for senior executives. Every nonprofit should have a code of ethics, a conflict-of-interest policy and a mechanism, such as an annual questionnaire, enabling board members and key executives to verify the absence of any conflicts or disclose any actual or potential conflicts. The results of this survey should be reviewed by the audit committee and, if needed, with the organization's independent auditor.

Oversight

In the case of non-profit health care providers, state attorneys general, state health departments and the IRS, among others, are expecting the governing boards of these organizations to be more accountable and proactive in ensuring that their organizations are fulfilling their legal responsibilities. As a result, increased board oversight will be necessary in key areas:

- ensuring high quality of care,
- keeping accurate records and billing correctly for all services,
- fulfilling the organization's charitable mission,
- justifying the organization's tax-exempt status,
- preserving protecting and getting maximum value from the organization's charitable assets, and
- avoiding conflicts of interest and self-dealing.

Moreover, not just government agencies but third-party payors, as well as lenders, underwriters, rating agencies and even insurers will be looking at an organization's compliance with these and other responsibilities as

part of their own due diligence when making financial commitments or credit assessments, or underwriting insurance coverage.

Guides

Board members should also be aware of a valuable new publication that is the result of a joint project between the Office of Inspector General of the U.S. Department of Health and Human Services and the American Health Lawyers Association. Entitled, "Corporate Responsibility and Corporate Compliance: A Resource for Health Care Boards of Directors," the publication offers a valuable guide to the responsibilities of board members in overseeing the effectiveness of their organization's corporate compliance program. The publication is free and is available at the OIG's Web site at <http://www.oig.hhs.gov> or at the AHLA Web site <http://www.health-lawyers.org>. The Healthcare Association of New York State is also in the process of preparing a "Non-Profit Corporate Accountability" guidebook for its member facilities and their board members. Both publications should provide useful guidance to nonprofit healthcare organizations as they move into this brave new world of transparency and accountability in corporate governance.

Of course, legislation and regulation can only go so far. Ultimately, good governance depends primarily upon how the governing body polices itself, its executives and the organization as a whole.

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