ask the legal professional

Waller Lansden Dortch & Davis

www.wallerlaw.com

Paul Gilbert
Member,
Waller Lansden Dortch & Davis
paul.gilbert@wallerlaw.com

Q *Has Sarbanes-Oxley Altered the Governance Standard of Nonprofit Boards?*

A: **It is beyond debate that Sarbanes-Oxley** or SOX has dramatically altered the landscape of public company governance and disclosure. The more interesting question is what SOX means for nonprofit directors. Will future plaintiffs argue successfully that an alleged financial misstep would not have occurred if the board had adopted SOX compliant governance standards? Perhaps.

Among other things, Sarbanes-Oxley obligates public companies to maintain audited financial statements certified by the CEO and CFO, create independent audit committees, adopt a code of ethics for financial officers and the CEO (unless the company discloses otherwise), ensure auditor independence and refrain from loans to directors and officers.

Except for its document retention, whistleblower retaliation and expanded obstruction of justice provisions, Sarbanes-Oxley does not expressly apply to nonprofit corporations. Under applicable state law, directors of nonprofit corporations, like their for-profit brethren, must provide oversight in a manner consistent with their fiduciary duties of care and loyalty. The duty often at issue, the duty of care, generally requires that directors act in good faith, in a manner reasonably believed to be in the best interests of the corporation, and with the care of an ordinarily prudent person. If the board meets these duties, the decisions made by a board – whether good or very bad – should not be subject to judicial review.

Notwithstanding this fact, a number of prominent nonprofit corporations have voluntarily revised their corporate governance standards to be consistent with certain SOX requirements. Why have they voluntarily subjected themselves to certain of the requirements of Sarbanes-Oxley, especially those that require certified financial statements and independent audit committees?

Many seem to have done so after concluding that such standards represent governance "best practices." Others likely have adopted enhanced standards after witnessing the vigor with which directors of Allegheny Health and Education Research Foundation (AHERF) were attacked following its bankruptcy, the corporate scandals of Enron and Worldcom, among others, and as a result of the increased scrutiny of nonprofit boards by the constituencies they serve, including governmental agencies, insurers, financial institutions and lenders, donors, the media and the public. Still others have adopted these heightened standards in response to developments at the state level (such as those in New York led by Eliot Spitzer) or in anticipation of enhanced federal scrutiny of tax exempt entities.

Whatever the reason, many nonprofit boards, especially those in highly regulated industries such as healthcare, have decided to adopt the governance standards of SOX.

Whatever the reason, many nonprofit boards, especially those in highly regulated industries such as healthcare, have decided to adopt the governance standards of SOX. To do so is certainly consistent with the common desire of mission-based organizations to avoid even the appearance of impropriety. As a result, it is reasonable to consider whether the care that would be exercised by an "ordinarily prudent person" may now be greater than it would have been prior to AHERF, Enron and SOX.

To be clear, a nonprofit corporation cannot, under current federal law, be found to have violated SOX (unless it violates one of the few provisions applicable to nonprofits). Given all that has happened in the world of corporate governance over the last few years, however, we think the reasonably prudent person would demand more than he or she would have demanded in the past. It is likely, at least in hindsight, that a court will determine that the ordinarily prudent person would have adopted certain minimal standards set forth by SOX.

We do not mean to suggest that nonprofit boards should rush to become fully SOX compliant. This is neither required by law nor feasible. Further, our SOX experience to date indicates that a "one size fits all" corporate governance mentality is unhelpful. We do believe, however, that it is prudent for nonprofit boards to review the state of their corporate governance standards and, if improvements are needed, to implement them.

Nonprofit boards might start by considering the following questions:

- Is the board active and engaged or is it controlled by or beholden to certain benefactors, management, a management company or a so-called "turnaround" specialist?
- Is the size and expertise of the board appropriate given the complexity of the business at issue? This is a case where 60 heads aren't necessarily better than 15.
- Does the board have an audit committee with "independent" and "financially literate" members? What is its relationship with outside auditors?
- What mechanisms are in place to allow the expression of employee concerns?
- Have all conflicts of interests been fully disclosed to the board? Does the nonprofit make loans or advance funds to any person?
- Are the nonprofit's code of ethics and document retention policies current?
- Finally, when is the last time the board considered the charitable mission, the quality of services being provided to its constituents, and the management or investment of charitable assets?

Nonprofit institutions have long been among the leaders in their commitment to corporate governance and transparency. Now it seems that Sarbanes-Oxley should be added to the total mix of information that nonprofit boards consider when evaluating their effectiveness.

Waller Lansden Dortch & Davis, PLLC 615-244-6380 www.wallerlaw.com

PAID ADVERTISEMENT