K&LNG Alert

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Health Care and Nonprofit Institutions Law

The Corporate Governance Tsunami

The Nonprofit Sector Increases Scrutiny on Governing Boards

WHAT SHOULD BOARDS BE DOING?

The wave of corporate governance reform appears to have reached the nonprofit sector in force. Over the last year, the Senate Finance Committee has conducted a series of hearings highlighting extraordinary and, in some cases, fraudulent practices of a very small number of exempt charitable organizations. There is an old legal adage that "bad facts make bad law" and, as is so often the case in Washington, these extreme examples were offered as evidence that Congress needs to pass tougher charitable organization oversight laws. Several quick but questionable proposals were offered, including, for instance, a requirement that each exempt charitable organization be required to apply to *renew* its tax exemption every five years. Imagine the difficulty in securing long-term, tax-exempt bond financing if an organization's exempt status were subject to revocation every 60 months.

At the encouragement of the Senate Finance Committee, the nonprofit world responded by convening the leaders of some of the nation's most prestigious tax-exempt entities to consider and recommend actions to strengthen ethical conduct, accountability, and governance of Charitable Organizations.

This "Panel on the Nonprofit Sector" (the "Panel") consisted of the presidents of, among others, the Ford Foundation, American Red Cross, United Way, YMCA of the USA, Rockefeller Brothers Fund, Pittsburgh Foundation and the American Cancer Society. Last month the Panel issued to the Senate Finance Committee a report entitled *Strengthening Transparency, Governance, Accountability of Charitable Organizations.* The heart of the report is a series of recommendations directed to Congress, the Internal Revenue Service, and to nonprofits generally, all of which offer a "comprehensive approach" to improving transparency and governance.

The recommendations cover 15 areas, including federal and state enforcement, board compensation, executive compensation, size and independence of the governing board, and conflict of interest and misconduct rules. The Chairman of the Senate Finance Committee has praised the report and indicated that it will be of "great use" to the Committee in drafting charitable reform legislation.

WHAT DOES THIS REPORT MEAN?

IT MEANS A LOT MORE DISCLOSURE

One of the key premises for this report is, to borrow the Panel's buzzword, increased *transparency*. The theme of *transparency* is apparent in a number of the Panel's recommendations: (i) requiring that more detailed information on the CEO's total compensation (salary & benefits) be disclosed on the Form 990, (ii) suggesting a disclosure of the process used by the board in setting executive compensation, (iii) requiring disclosure of the existence of a corporate conflict of interest policy and compliance program, and (iv) suggesting the publication of a detailed report of the entity's operations.

For many in the nonprofit world, these additional disclosures might be uncomfortable and perhaps unwelcome. One of the first experiments with transparency was the publication of CEO salaries on the Forms 990 and the posting of the Forms 990 on the web. This made a number of nonprofit CEOs uncomfortable; some decided to form for-profit management companies and place their salaries into the for-profits' contract management fee (thereby masking the salaries); others divided their salaries among several for-profit and nonprofit affiliates, making the complete salary package difficult to calculate. The impact of the posting of Forms 990 on the web has been understated, however. Most people did not bother to track down the Forms 990 and the reports usually lagged a few years behind, which made the information less useful. Those who went to the trouble to track salaries realized that, more often than not, there was comparability among executives in similar institutions. In any event, most people are no longer shocked by six-figure salaries for nonprofit executives. (The fact that the salaries of for-profit executives increased at a seemingly higher pace helped blunt the impact of nonprofit salaries.) It seems clear,

Recommendations to Congress

The following are some of the Panel's recommendations to Congress. Congress would need to enact legislation to effect these suggestions:

1. Permit the IRS to share information with the state attorneys general and other state agencies. This means additional scrutiny from state agencies. Some states have been very actively engaged in monitoring charities; others have been passive. If this is enacted, the active states will have more information and the passive states will have more motivation.
2. Increase appropriations to the IRS and to states for more oversight (which means more auditing).
3. Require electronic filings for all annual tax returns (Forms 990) and the initial applications for exemption (Forms 1023). Electronic filings are easier for the IRS to process and allow a smoother transition to potential web postings and retrievals by outside third parties.
4. Increase penalties for directors and managers who approve so-called "excess benefit" transactions and for

those who receive the excess benefits. "Excess benefit" transactions are transactions (including transfers of goods or money and payment of compensation) between the entity and an "insider" in which the transaction is tilted in favor of the insider, who receives more value from the transaction than the entity (a/k/a a "sweetheart deal").

5. Enlarge the accountability standard for directors who approve excess benefit transactions from knowing that a transaction is improper to "*should-have-known*" that a transaction is improper and provide that the failure of a board to use the so-called "rebuttable presumption of reasonableness" (which is a procedure analyzing a proposed transaction for fairness and consistency with industry standards) can be pointed to as evidence of failing the *should-have-known* standard.
6. Abate penalties for committing an excess benefit transaction if the entity has complied with the rebuttable presumption standards.
7. Require one-third of the board to be comprised of *independent* directors.

however, that more disclosure is inevitable. The IRS is currently in the process of revising the Form 990. Some of the Panel's recommendations may appear on the new Form.

MORE SCRUTINY

Another clear and immutable trend is that the public, the media, the federal government, and increasingly state governments, are stepping up their scrutiny on nonprofits. This reality will not abate; it will only increase.

A perfect example of this is the way in which the Panel has elected to deal with the so-called "rebuttable presumption of reasonableness." The rebuttable presumption is a convention created by the IRS, which allows the IRS and the nonprofit entity to assume that a transaction between the nonprofit entity and its insiders will be regarded by the Service as a legitimate transaction rather than a prohibited excess benefit transaction. Since excess benefit transactions can result in onerous taxes on the recipient (*i.e.*, the insider) and those approving the transaction (*i.e.*, directors), avoiding them is important.

In order to qualify for the presumption, the entity's "authorized body" (usually, the board or an authorized committee acting in accordance with a conflict of interest policy) must itself be independent and conflict-free and must do three things:

1. approve the financial aspects *in advance;*
2. obtain and rely upon appropriate data as to comparability *prior* to making its determination; and
3. adequately document the basis for its determination.

If an entity follows these three steps, the transaction is presumed to be legitimate, although the IRS can rebut the presumption by introducing contrary evidence. However, the burden for the IRS is much more difficult to meet in this instance.

Importantly, up to this point the IRS cannot draw a negative conclusion if the board fails to qualify for the presumption. However, the Panel has issued a companion recommendation to create a second standard to judge a board's behavior. Previously, directors or managers were culpable if they *knew* that a transaction was unfair or imbalanced. The Panel is recommending that directors or managers could be culpable if they *should have known* that the transaction was questionable and they failed to use reasonable care in analyzing the transaction. The Panel suggests that *an example of not exercising reasonable care would be the failure to follow the steps essential to effect the rebuttable presumption.* In effect, failure to follow the rebuttable presumption, which at the moment creates no negative connotations, could create a negative connotation if the Panel's suggestion is accepted.

The failure to qualify for the presumption has a second potential impact because the Panel suggests that the charity disclose on its Form 990 whether it followed the rebuttable presumption procedures in determining the reasonableness of the executive's compensation.

What does this mean for health care providers? It means that boards will need to rely upon legitimate comparative data in setting CEO salaries. Merely relying on a historical basis for compensation will not be enough. Boards would be wise to consider performing a *comprehensive* executive compensation survey covering the CEO and senior management and addressing salary *and* benefits. The comprehensive evaluation should be performed every three or four years with annual updates in between.

Recommendations to the IRS

The following are recommendations directed to the IRS:

1. Revise the Form 990 to ensure more accurate reporting and the provision of specific information relevant to federal and state enforcement efforts. (The IRS is already in the process of revising the Form 990.)
2. Require entities to disclose the composition and compensation of its board and to identify those directors who are *independent* directors.
3. Require full disclosure of executive compensation by using SEC forms (which require information on all

Every institution has its own priorities at different stages of its life cycle. For instance, some entities are trying to recruit new talent, others are trying to retain talent, and others are trying to allow a senior executive to trade cash compensation for more generous retirement accruals. A comprehensive compensation review asks the board to identify its main performance and strategic objectives and then builds the compensation system around these objectives. A board is well-served by tying compensation to corporate objectives (*e.g.*, by incentive payments); and it is defensible and easily understood by the board and management.

MORE INDEPENDENCE

One of the themes stressed in the Panel's report and being repeated in virtually all articles and analytical pieces discussing board governance is the notion of a director's

benefits and perks) and a disclosure as to whether the board followed the rebuttable presumption of reasonableness in establishing executive compensation.

4. Require entities to disclose on their Forms 990 whether they have a conflict of interest policy and travel policy for top executives and directors.
5. Increase the penalties for incomplete or inaccurate reporting on the Form 990 or other required federal documents.

independence. This is obviously a theme emanating from the Enron and WorldCom disasters. The Panel recommends that *one-third* of the directors be independent.

According to the Panel, an independent board member is an individual:

1. who has not been compensated by the organization within the past 12 months,
2. whose own compensation is determined by individuals who in turn are not compensated by the organization,
3. who do not receive either directly or indirectly any material benefits from the organization (other than being a member of the class served by the organization, such as a tissue or organ recipient), and
4. who is not related as a spouse, sibling, parent, or child to any of the persons described above.

Independence is viewed by many observers as being the most critical component of an effective board. The NYSE, corporations, large investors (*e.g.,* CALPERS) have all established their own definitions of independence. The Panel's report is likely to gain traction because it is simple and straightforward. The board should inventory its membership against the Panel's criteria for independence to determine which directors are independent.

The question of how many directors are independent is not the end of the inquiry. It is also important to determine in which capacities these individuals serve. Clearly, there is a preference for an independent director to serve as the chairman of the audit, finance and nominating/governance committees, and there is a great deal of literature that *each* of the members of each of these committees should be independent directors as well.

The flip side of the coin to independence is a conflict of interest policy. The Panel requires or suggests that a comprehensive conflict of interest program be initiated, including indicating in the Form 990 and otherwise whether such a process exists.

One of the anticipated objectives of independence is an enhanced ability to point out flaws or improprieties within the entity. Not unexpectedly, the Panel has enhanced its independence recommendation with a suggestion that there be an adequate whistle-blower or compliance process in place as well. The whistle-blower protection provision is already required of nonprofits by Sarbanes-Oxley.

WHAT SHOULD A CEO DO WITH THIS REPORT?

The most important principle is for CEOs to understand that governance is a **"board process,"** and the board must assume responsibility for its governance structure and function. It is difficult for a CEO who feels a strong kinship (if not a direct survival instinct) with his or her board to want to or to actually manage the board. However, the logic underlying the recent good governance movement is for the board to assume responsibility for **its** structure and function. The role of the CEO in this respect is to educate the board and to act as a catalyst to have the board undertake this process for itself.

So, what does the CEO do?

1. First, the CEO should provide for educational programs addressing current trends in the field of nonprofit governance and the enormous activity being undertaken in this area. This could include retreats, seminars, or outside speakers.
2. Second, the CEO should suggest to the board that it create a standing governance committee to address these issues. A governance committee is not an executive committee; an executive committee is typically involved with operational matters. A governance committee, on the other hand, addresses board operational and structural matters, *e.g.,* meeting length and format, designation of independence status, self-assessment survey, conflict of interest protocols, etc. One possibility is to expand the role of the nominating committee and have it assume the role of the governance committee.

Recommendations for Charities

The following are recommendations for charities to consider implementing on their own:

1. Require the *full* board to review and approve CEO compensation on an annual basis. If the board uses a compensation expert to evaluate CEO compensation, the expert should be independent and report directly to the board (not management).
2. Have the board or a compensation committee conduct a periodic review of the compensation program for the entire staff (including salary ranges and benefits for particular positions).
3. Periodically conduct a self-analysis to determine whether the board contains the necessary expertise, is sized effectively and work is distributed efficiently among all directors.
4. Publish "detailed information about its operations" (including methods used to evaluate the outcome of its

programs) through an annual report or a web site. (This is likely to be a controversial recommendation. Its vagueness suggests that the Panel is comfortable leaving implementation up to the entity.)

5. Adopt and enforce a conflict of interest policy specifically tailored to the characteristics of the organization.
6. Adopt travel policies consistent with IRS regulations, including identifying categories of appropriate travel expenses as well as rules for traveling with spouses or significant others.
7. Adopt a compliance and reporting process so that individuals with credible information on potentially illegal practices feel comfortable coming forward.
8. Undertake education efforts regarding the roles and responsibilities of directors.

3. Third, the CEO has to encourage and prompt the board to study and adopt principles of good governance and best practices. The art of the process is for the CEO to encourage the board to move, but for the CEO not to be too far in front of the board; the board should not perceive this as a "management function." In the final instance, this is a process that has to be owned by the board, not by the CEO.

The unmistakable trend in the media and Congress is that good governance for nonprofits is essential. It is unlikely that this trend will fizzle out. The result is that either nonprofits themselves (through organizations like the Panel on the Nonprofit Sector) will adopt their own standards, or standards will be imposed upon the field by Congress, the IRS, or state attorneys general. Each nonprofit entity has the choice of being on the beginning, the middle, or the end of this curve. Educating your board, explaining the reasons and rationales behind the Panel, and suggesting a mechanism for the board to approach its governance responsibilities is common sense.

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