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. OPOs have 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's recommendations, and suggesting a mechanism for the board to approach its governance responsibilities is not only common sense but it increases the credibility of OPOs with CMS during the pendency of the adoption of final regulations.

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K&LNG Alert

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Health Law

The Corporate Governance Tsunami:

CMS and the Nonprofit Sector Increase Scrutiny on Governing Boards. What Should OPOs 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 charitable organizations ("COs"). 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 bad 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 COs.

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 its report entitled *Strengthening Transparency, Governance, Accountability of Charitable Organizations, A final report to congress and the Nonprofit Sector.*[1] The heart of the report is a series of recommendations directed to Congress, the Internal Revenue Service, and to COs generally, all of which offer a "comprehensive approach" to improving transparency, financial accountability 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.

[1] The report can be found at www.independentsector.org.

CMS IS INTERESTED IN GOVERNING BOARD STRUCTURE, TOO.

In its proposed Conditions of Participation (COPs) issued in February 2005, CMS devoted a considerable amount of time and effort discussing needed improvements in OPO board governance. The crux of these discussions focused on the "independence" of OPO directors and the inverse thereto, director conflicts of interest, most notably from transplant centers serving on an OPO board. The proposed regulations clearly signaled CMS's interest in and efforts to enhance the structure and effectiveness of OPO boards.

If OPOs were to embrace and adopt many of the enhancements suggested by the Panel, they would clearly improve governance and would send a very convincing message to CMS that OPOs are interested and committed to better governance. This, of course, would enhance the credibility of OPOs comments on the governance portion of the proposed regulations.

WHAT DOES THIS MEAN?

MORE DISCLOSURE

One of the key premises for this report is, to borrow the Panel's buzz word, 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 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 would 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 salary into the for-profit's contract management fee (thereby masking the salary); 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. 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, however, that more disclosure is inevitable. The IRS is currently in the process of revising the Form 990. Some of the Panel's recommendations will likely 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 entities to assume that a transaction between an entity and its insiders will be regarded by the Service as a legitimate transaction rather than a prohibited excess benefit transaction. It is important to avoid "excess benefit" designation because if a

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, which typically have been very passive toward charities.)
2. Increase appropriations to the IRS and to the states for more oversight (which means more auditing).
3. Require electronic filings for all annual tax returns (Forms 990) and the initial application 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. Broaden 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 entering into 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. (This has major implications for OPO boards.)

transaction is considered to be an excess benefit transaction, the recipient (i.e., the insider) and those approving the transaction (i.e., directors) are subject to penalties and excise taxes.

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 do three things:

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

If a 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 more difficult to meet in this instance.

Importantly, the IRS currently cannot draw a negative conclusion simply 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 unbalanced. 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 suggest 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 to OPOs? It means that OPO boards will need to rely upon legitimate comparative data in setting CEO salaries. Merely relying on an OPO's historical basis for compensation will not be enough. This is good news for executive compensation consultants.

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 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 hasn't 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,

Recommendations to the IRS

The following are some of the Panel's 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 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 990s 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.

Should OPOs, Through AOPO, Create Their Own Data Bank?

Because the field is so small (there are only 58 CEOs) and information regarding executive compensation is closely held, useful compensation comparative information can be difficult to gather. From an OPO's perspective, it could be receiving queries from other OPOs (or their compensation consultants) all through the year given the different fiscal years of the different OPOs.

Perhaps a more efficient mechanism would be for AOPO to engage an outside firm to create an off-site data bank that could be accessed by each of the AOPO members (or perhaps only by their consultants) on a "blind" (i.e. no name) basis. If the data bank is run by an independent third party, the security of confidential information would be maintained and the vendor's cost to operate the vendor could be split among the 58 OPOs. By doing this, the board of each OPO could be assured that it is getting reliable data rather than receiving outdated, anecdotal, and possibly incomplete compensation data, particularly as it relates to benefit packages. The data could be indexed according to any number of variables, including an entity's revenues, site of its headquarters, years in position, number of organ donors, etc. Such a bank would give directors an adequate, accurate, and real time basis for making comparable salary determinations.

3. who don't 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 isn't 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. In the case of OPOs, the obvious concern is the role, or in some cases the dominance, of transplant centers on the OPO boards.

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 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 recommendation for independence with a suggestion that there be an adequate whistle blower and compliance process in place as well.

The independence theme is not restricted to the Panel recommendations. As mentioned earlier, independence is a dominant theme running through CMS's proposed COPs. While it may be easy to conclude that directors from transplant centers are not independent, it is not quite so easy to determine the independence of other types of directors, such as organ recipients, individuals who are presently on an organ waiting list, coroners or medical examiners, or tissue bank representatives, to name a few. Nonetheless, given the unrelenting emphasis on independence, each board is going to have to tackle the issue of defining independence for itself and should determine whether at least one-third of its board can be comprised of independent individuals.

The question of the number of independent directors is not the end of the inquiry. It is also important to review the positions in which 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 concluding that *each* of the members of each of these committees should be independent directors as well.

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 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 website. (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.

WHAT SHOULD AN OPO EXECUTIVE DIRECTOR DO?

The most important principle for executive directors to understand is that this is a **board process,** and the board must assume responsibility for its governance structure and function. It is difficult many times for an executive director, who feels a strong kinship (if not a direct survival instinct) with his or her board, to either want to or actually be in the habit of managing 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 executive director 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 an executive director do?

1. First the CEO should provide for educational programs on 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. It also means suggesting to the board that it create either a standing or ad hoc governance committee to address these issues, or that the executive or nominating committees of the board undertake this function.
2. Second, the executive director has to encourage and prompt the board to study and adopt principles of good governance and best practices. The art of the process is to encourage the board to move, without being too far in front of the board so that the board perceives it as "another 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 with hospitals, universities, foundations, and, most importantly, the media and Congress, is that good governance for nonprofits is