

**Accountability, Transparency and Governance
for Nonprofits**

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printed as a resource for Montana's nonprofit community



THE MONTANA COMMUNITY FOUNDATION

cultivating philanthropy to build Montana's future

PREFACE

The nonprofit community, whether by law or public expectation, faces the reality that it must increase its accountability, transparency, and governance. It benefits us all to become familiar with the discussions being held in Congress on nonprofit re-regulation and new standards being promulgated by our certifying organizations, weigh-in with our opinions, and prepare.

To follow are three reprinted articles that summarize recommendations being considered by Congress; make suggestions for increasing accountability, transparency, and governance now; and help evaluate what our next steps should be.

ONE Executive Summary of the Report to Congress made by the Non-Profit Sector. In 2004 the Chairman and Ranking Member of the Senate Finance Committee convened a panel representing the nonprofit sector to review the sector's governance, transparency, and ethical standards. Following the review, the panel was asked for recommendations that would lead to higher standards in all three areas. Those recommendations are contained in this Executive Summary. The panel is continuing its work and plans to release an addendum to its final report covering nine additional topics. To read the draft recommendations on these subjects go to www.nonprofitpanel.org.

TWO Ten Emerging Principles for Governance of Nonprofit Corporations and Guides to a Safe Harbor. This article by Tom Silk, whose firm specializes in nonprofit law, provides suggestions that all non-profits can begin to incorporate into their policies and procedures now.

THREE Summary Checklist for Accountability. Prepared by the Independent Sector and the Panel on the Nonprofit Sector, this check list is a good place to begin to understand how your nonprofit organization's policies and procedures align with the public's expectations of how we conduct our work.

The Montana Community Foundation does not agree with all of what you will read here. Our goal in reprinting these articles together is to provide a consolidated, concise summary of potential regulatory changes and suggestions for actions you can take now to respond to increasing public expectations. There are interesting times ahead for us all.

The Montana Community Foundation has received permission to reprint these articles.

The following is the executive summary from the Panel on the Nonprofit Sector's report "Strengthening Transparency, Governance, and Accountability of Charitable Organizations, a final report to Congress and the Nonprofit Sector, June 2005"

ONE EXECUTIVE SUMMARY

The Panel on the Nonprofit Sector is dedicated to ensuring that Americans continue to benefit from the richly varied programs provided by the charitable community. Formed at the encouragement of the leaders of the Senate Finance Committee, the Panel has led to an unparalleled collaboration on how to strengthen the sector's accountability, transparency, and governance. The participants in this effort—thousands of people representing diverse organizations from every part of the country—recognize that to serve their missions effectively, they must demonstrate that they are ethical, responsible stewards of Americans' generosity. The Panel developed eight overarching principles to guide its recommendations:

The Role of Charitable Organizations in American Life

1. A vibrant charitable community is vital for a strong America.
2. The charitable sector's effectiveness depends on its independence.

The Responsibilities of the Charitable Community

3. The charitable sector's success depends on its integrity and credibility.
4. Comprehensive and accurate information about the charitable sector must be available to the public.
5. A viable system of self-regulation and education is needed for the charitable sector.

The Need for Balanced Government Oversight

6. Government should ensure effective enforcement of the law.
7. Government regulation should deter abuse without discouraging legitimate charitable activities.
8. Demonstrations of compliance with high standards of ethical conduct should be commensurate with the size, scale, and resources of the organization.

RECOMMENDATIONS

The recommendations of the Panel on the Nonprofit Sector are a carefully integrated package that calls for improvement within the sector, more effective oversight, and changes in the law. No single action can achieve the necessary results by itself. The recommendations underscore the importance of transparency, of providing the information that allows the public to make informed choices and government officials to root out problems. Most important, the recommended actions offer a guide to maintaining the essential balance between adequate oversight that keeps potential abusers from using the sector to benefit themselves and safeguarding the independence of organizations in facilitating the opportunity for them to contribute to the well being of society.

Summary of Recommendations

The detailed discussions in the report note important exceptions for organizations of particular types and sizes and other conditions that must be considered in the implementation of these recommendations.*

* Recommendations for changes in the law or regulations would primarily apply to organizations required to file a Form 990 or 990-PF, and thus smaller organizations or religious congregations would generally be exempt. The discussion contained in the report gives further details.

1. Federal and State Enforcement—Effective oversight of the charitable sector requires vigorous enforcement of federal and state law. Congress should increase the resources allocated to the Internal Revenue Service for overall tax enforcement and oversight of charitable organizations, and it should create a federally funded program to help states establish or increase oversight and education programs for charitable organizations. Congress should also eliminate statutory barriers that prevent the IRS from sharing information about investigations of possible wrongdoing with state charity officials.

2. Internal Revenue Service Reporting—The annual information returns filed by charitable organizations (Forms 990, 990-EZ, and 990-PF) should be improved so they provide more accurate, complete, and timely information for federal and state regulators, managers of charitable organizations, and the public. Electronic filing will increase accuracy and compliance in completing the returns, and Congress and the IRS should remove the legal barriers to requiring electronic filing of the returns by all charitable organizations. Congress should impose penalties on preparers who willfully omit or misrepresent information on the returns. Congress also should direct the IRS to require the organization's highest ranking officer to sign and certify the Form 990, as well as institute a new, brief annual reporting requirement for organizations with less than \$25,000 in annual revenues. The IRS should make a number of changes in the format and instructions for Form 990 series returns, and suspend the tax-exempt status of any charitable organization that fails to correct incomplete or inaccurate returns for two consecutive years. The board of a charitable organization, or an appropriate committee, should review its organization's Form 990 series return.

3. Periodic Review of Tax-Exempt Status—Congress should not implement a new periodic review system to verify that a charitable organization continues to meet the qualifications for tax-exemption. The IRS should focus its resources on review and investigation of the current returns filed by charitable organizations. In addition, boards of directors are encouraged to undertake a full review of their organizations' governing documents and policies at least once every five years.

4. Financial Audits and Reviews—Having financial statements prepared and audited in accordance with Generally Accepted Accounting Principles and auditing standards improves the quality of financial information available to governing boards, government officials, and the public. Congress should require charitable organizations with at least \$1 million or more in annual revenues to conduct an audit and attach audited financial statements to their Form 990 series returns, and those with annual revenues between \$250,000 and \$1 million to have their financial statements reviewed by an independent public accountant.

5. Disclosure of Performance Data—Every charitable organization should, as a recommended practice, provide more detailed information about its operations, including methods it uses to evaluate the outcomes of programs, to the public through its annual report, website, and other means. The Form 990 returns are not useful as a tool for reporting complex program evaluation information. Congress should not require charitable organizations to report more detailed statements of program evaluations or performance measures as part of their Form 990 series returns.

6. Donor-Advised Funds—Laws and regulations governing donor-advised funds should be strengthened to ensure that donors or related parties do not receive inappropriate benefits from these funds. Congress should amend tax laws to define and regulate donor-advised funds, including requiring sponsoring charities to make minimum distributions of 5 percent of aggregate donor-advised fund assets and enforcing minimum fund activity requirements. Congress also should prohibit sponsoring charities from making payments to a private foundation or directly or indirectly to the fund's donors, advisors, or related parties. Further, tax deductions for contributions to donor-advised funds should be allowed only if the

donor has a written agreement with the sponsoring charity clarifying these restrictions. Penalties should be imposed on donors, advisors, and managers who violate these prohibitions. More information about the assets held by and disbursements made from donor-advised funds will improve both enforcement and understanding of these funds, and each sponsoring charity should be required to disclose aggregate information about its donor advised funds on its Form 990. Sponsoring charities are encouraged to provide further information about their donor-advised funds to help others learn more about how the funds are distributed.

7. Type III Supporting Organizations—Type III supporting organizations add value to the charitable sector that cannot and should not be replaced by other types of organizations. To curb abuse in these organizations, Congress should establish minimum distribution requirements, prohibit payments to or for the benefit of donors or any related party, and institute rules to increase the voice of the supported organizations in the governance of the Type III organization. A Type III supporting organization should be prohibited from supporting more than five qualified entities or from supporting any organization that is controlled by the donor or a related party. It should be required to provide certain documents to, and confirm the agreement of, its supported organizations at the time it files for recognition as a 501(c)(3) organization and when it files its annual Form 990 returns. Every supporting organization should be required to indicate on its Form 990 whether it is operating as a Type I, II, or III supporting organization.

8. Abusive Tax Shelters—Congress should make clear that all tax-exempt organizations, including those not currently required to file tax returns, are subject to the same requirements as taxable entities with regard to reporting their participation in potentially abusive “listed” and other “reportable” tax shelter transactions, and should impose penalties on organization managers for failure to report if they knew or had reason to know that the transaction was a reportable transaction. Congress should impose penalties on taxable participants and material advisors who fail to notify tax-exempt participants that they would be engaging in a reportable transaction, and should ensure that appropriate sanctions are imposed on tax-exempt entities that knowingly participate in abusive tax shelters. Education will be key to both compliance with and enforcement of tax laws governing these complex transactions, and the IRS should be required to provide the clear, up-to-date, readily accessible information that charitable organizations need to determine whether a transaction is potentially abusive and whether they are under an obligation to disclose participation in a transaction.

9. a. Non-Cash Contributions: Appreciated Property—Congress should strengthen the rules for the appraisals taxpayers can use to substantiate deductions claimed for property donated to charitable organizations and increase penalties on (1) taxpayers who claim excessive deductions based on an overstated value for the donated property and (2) appraisers who knowingly provide overstated appraisals. The Forms 8282 and 8283, which are filed, respectively, by taxpayers who claim tax deductions for donated items valued at \$5,000 or more and by charitable organizations that dispose of those items within two years of the donation, could be a useful enforcement trigger for the IRS, and Congress should require those forms to be filed electronically.

b. Non-Cash Contributions: Conservation and Historic Façade Easements—A conservation easement or historic façade easement donation requires ongoing enforcement of the terms of the easement agreement by the charitable organizations who accept such donations. Congress should increase penalties on taxpayers who claim excessive deductions for donations of conservation or historic façade easements and should only permit a deduction for an easement if it is made to a qualified charity or government entity under the terms of a written agreement that specifies the restrictions the easement imposes on future use of the property. A charitable organization that accepts easement donations should be required to provide more information on its annual Form 990 about the easements it holds

and to certify that it has implemented reasonable procedures for monitoring compliance with the terms of its easement agreements. Congress should impose penalties on charities that fail to enforce conservation or historic façade easement agreements.

c. Non-Cash Contributions: Clothing and Household Items—Congress should not limit deductions for contributions of clothing or household items to an arbitrary ceiling without a clear basis for establishing the amount of the ceiling and an assessment of the impact of the change on the level of charitable contributions. To assist taxpayers in valuation, the IRS should establish a list of the value that taxpayers can claim for specific items of clothing and household goods, based on the sale price of such items identified by major thrift store operations or other similar assessments.

10. Board Compensation—Compensation to board members of charitable organizations is discouraged. Charitable organizations that do provide compensation to board members should be required to disclose the amount of and reasons for the compensation, as well as the method used to determine its reasonableness. Congress should prohibit public charities from providing loans to board members (such loans are already illegal for private foundations). Congress should also increase penalties on board members of charitable organizations who receive or approve excessive compensation.

11. Executive Compensation—Charitable organizations should be required to disclose more clearly the compensation paid to their chief executive officer and other “disqualified persons” and to the five highest compensated employees. Congress should require officers and other disqualified persons who receive compensation that the IRS alleges is excessive to demonstrate that their compensation is reasonable, and should increase penalties imposed on individuals who receive and managers who approve excessive compensation. Members of boards or other authorized bodies who followed the rebuttable presumption procedures in determining the reasonableness of compensation should not ordinarily be subject to penalties, even if the compensation is later found to be excessive, but penalties should be imposed on board members and managers who approved such compensation if they did not follow those procedures nor otherwise exercised reasonable care in approving the transaction. As a matter of good practice, the full board of charitable organizations should approve any change in the compensation of the CEO annually and in advance and review the organization’s full staff compensation program periodically.

12. Travel Expenses—Charitable organizations that pay for or reimburse travel expenses of board members, officers, employees, consultants, volunteers, or others traveling to conduct the business of the organization should establish and enforce policies that provide clear guidance on their travel rules, including the types of expenses that can be reimbursed and the documentation required to receive reimbursement. With the exception of de minimis expenses of those attending an activity of the organization (such as a meal function), charitable organizations should not pay for nor reimburse travel expenditures for a spouse, dependents, or others who are accompanying an individual conducting business for the organization unless the additional person is also conducting business for the organization. Charitable organizations should be required to disclose on their Form 990 series returns whether they have a travel policy. The IRS should provide information in the instructions to the Forms 990 about travel costs that are not permitted or that should be reported as taxable income.

13. Structure, Size, and Composition of Governing Boards—To qualify for recognition as a 501(c)(3) tax-exempt organization, an organization should generally be required to have a minimum of three members on its governing board. Further, to qualify as a public charity (rather than a private foundation), at least one-third of the members of the organization’s governing board should be

independent: that is, individuals who have not received compensation or material benefits directly or indirectly from the organization in the previous 12 months, whose compensation is not determined by other board or staff members, and who is not related to someone who received such compensation from the organization. Every charitable organization should be required to disclose on its Form 990 series return which of its board members are independent. Individuals barred from service on corporate boards or convicted of crimes related to breaches of fiduciary duty should be prohibited from serving on the boards of charitable organizations. Federal tax laws or regulations should *not* set a maximum number of members for the governing boards of charitable organizations. Every charitable organization should, as a matter of recommended practice, review its board size periodically to determine the most appropriate size to ensure effective governance and to meet the organization's goals. All boards should establish strong and effective mechanisms to ensure that the board carries out its oversight functions and that board members are aware of their legal and ethical responsibilities in ensuring that the organization is governed properly.

14. Audit Committees—Charitable organizations should include individuals with some financial literacy on their boards of directors in accordance with the laws of their state or as a matter of recommended practice. Every charitable organization that has its financial statements independently audited, whether legally required or not, should consider establishing a separate audit committee of the board. If the board does not have sufficient financial literacy, and if state law permits, it may form an audit committee comprised of non-staff advisors who are not board members.

15. Conflict of Interest and Misconduct—As a matter of recommended practice, charitable organizations should adopt and enforce a conflict of interest policy consistent with its state laws and organizational needs. The IRS should require every charitable organization to disclose on its Form 990 series return whether it has such a policy. Charitable organizations should also adopt policies and procedures that encourage and protect individuals who come forward with credible information on illegal practices or violations of adopted policies of the organization. There should be a vigorous sectorwide effort to educate and encourage all charitable organizations, regardless of size, to adopt and enforce policies and procedures to address possible conflicts of interest and to facilitate reporting of suspected malfeasance and misconduct by organization managers.

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TWO TEN EMERGING PRINCIPLES OF GOVERNANCE OF NONPROFIT CORPORATIONS AND GUIDES TO A SAFE HARBOR

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When clients look to legal counsel for advice and guidance, they expect to hear about current law. Sophisticated clients also look to us to keep them ahead of the curve, to alert them to evolving developments and trends in relevant laws and norms. This paper represents my attempt to peer around the corner, to report on what I see, to identify and discuss what I believe to be the major developments and trends in principles of governance of nonprofit corporations, and to point the way to a safe harbor. This paper is entirely subjective. It reflects my views alone, not necessarily those of my colleagues nor of my clients.

The passage of Sarbanes-Oxley is a “wake-up call to the entire nonprofit community. If nonprofit leaders do not ensure effective governance of their organizations, the government may step forward and also regulate nonprofit governance.”

The Sarbanes-Oxley Act and Implications for Nonprofit Organizations
(Independent Sector and BoardSource, 2003)

“Public trust in our sector demands enforcement of legal standards, but it calls for more than that. Our world is migrating from a standard of what the law ‘allows’ us to do, to what we are comfortable reading about ourselves in the newspaper.”

Dorothy S. Ridings, President of the Council on Foundations,
Foundation News (November-December, 2003)

“I do think the changes in corporate governance that we’re seeing through the voluntary best practices codes, for example ... have created a new set of expectations for directors. And that is changing how courts look at these issues.”

Chief Justice Veasey, Supreme Court of Delaware,
“What’s Wrong with Executive Compensation,”
Harvard Business Review, pp. 68, 76 (January, 2003)

INTRODUCTION

In response to the corporate scandals at Enron, Arthur Andersen, Global Crossing, and other major corporations, Congress passed the Sarbanes-Oxley Act of 2002. Scholars (including judges) have pondered the possible implications of Enron for the law of corporations.¹ Corporate watchdog organizations and professional associations of business and law have advocated and adopted more rigorous best practice codes of corporate governance.²

Meanwhile the press has reported on scandals within the nonprofit sector as well.³ So far nonprofit organizations have not been the target of reform legislation by Congress. States have been the first to act, with legislation patterned after Sarbanes-Oxley⁴ introduced in New York and California.⁵

What new principles of governance are likely to emerge for the nonprofit sector? Based on an analysis of recent developments in the for-profit sector, including Sarbanes-Oxley and the recent spate of best practice codes of governance, I have identified ten likely emerging principles of governance for nonprofit organizations. My intent is not to hazard a prediction about the likelihood of federal or state legislation or regulations but to recognize and reflect the emergence of a fundamental aspirational shift. Whether or not additional legislation is enacted, community customs and practices are changing. Those changes may lead to revised interpretations by courts of the fiduciary duties of care and loyalty of directors of nonprofit corporations because the meaning of these terms is based on current custom and practice.⁶ Moreover, a higher level of public expectation may prompt increased media scrutiny of nonprofit sector organizations. The likelihood of enforcement of federal and state laws regulating charitable organizations will continue to be less of a practical deterrent against improper conduct than the risk of reputational harm that may result from adverse media publicity targeting the nonprofit corporation, its directors and officers.⁷

EMERGING PRINCIPLES

- 1.** The board of directors of a nonprofit corporation must engage in active, independent, and informed oversight of the activities of the corporation, particularly those of senior management.
- 2.** Directors with information and analysis relevant to the board's decision making and oversight responsibilities are obligated to disclose that information and analysis to the board and not sit passively. Senior management should recognize and fulfill an obligation to disclose—to a supervising officer, to a committee of the board, or to the board of directors—information and analysis relevant to such person's decision making and oversight responsibilities.
- 3.** Every nonprofit corporation should have a nominating/governance committee composed entirely of directors who are independent in the sense that they are not part of the management team and they are not compensated by the corporation for services rendered to it, although they may receive reasonable fees as a director. The committee is responsible for nominating qualified candidates to stand for election to the board, monitoring all matters involving corporate governance, overseeing compliance with ethical standards, and making recommendations to the full board for action in governance matters.
- 4.** Every nonprofit corporation with substantial assets or annual revenues should develop and implement a three-tier annual board evaluation process whereby the performance of the board as a whole, each board committee, and each director are evaluated annually. The board should also develop and implement a process for review and evaluation of the chief executive officer on an annual basis.
- 5.** Each board of directors is responsible for overseeing corporate ethics. Ethical

conduct, including compliance with the requirements of law, is vital to a corporation's sustainability and long-term success. To establish an ethical corporate culture, the board should consider the following actions:

- communicate to personnel at all levels of the corporation a strong, ethical "tone at the top," set by the board, the chief executive officer, and other senior management, establishing a culture of legal compliance and integrity;⁸
- assign to the chief executive officer or other officer the specific task of serving as compliance officer;
- adopt a Conflicts of Interest policy;
- include ethics-related criteria in employee qualification standards and in employees' annual performance reviews.

6. Every nonprofit corporation with substantial assets or annual revenue should be audited annually by an independent auditing firm. The corporation should change auditing firms or the lead and reviewing audit partner periodically to assure a fresh look at the firm's financial statements. The audit committee should be composed of completely independent directors and should set rules and processes for complaints concerning accounting and internal control practices. It is responsible for hiring, setting compensation, and overseeing the auditor's activities.

7. The chief executive officer and the chief financial officer of every nonprofit corporation should review Form 990 or Form 990-PF and other annual information returns filed by the nonprofit organization with federal and state agencies.

8. Any attorney providing legal services to a nonprofit corporation who learns of evidence that the attorney reasonably believes indicates a material breach of fiduciary duty or similar violation shall report that evidence to the chief executive officer of the nonprofit corporation and, if warranted by the seriousness of the matter, to the board of directors.

9. Every nonprofit corporation should adopt a written policy setting forth standards for document integrity, retention, and destruction. Section 1102 of the Sarbanes-Oxley Act provides that whoever alters or destroys any document with the intent to obstruct the investigation or proper administration of any matter within the jurisdiction of any federal agency or department is guilty of a felony. This provision applies to individuals within nonprofit corporations as well as business corporations.

10. Every nonprofit corporation should adopt a written policy to permit and encourage employees to alert management and the board to ethical issues and potential violations of law without fear of retribution. This is based on Section 1107 of the Sarbanes-Oxley Act which treats as a felony any discharge, demotion, or harassment of any employee who provides to a law enforcement official true information about the potential commission of a federal offense. This provision also applies to individuals within nonprofit corporations as well as business corporations.

COMMENTARY

The ten principles of governance are derived primarily from four sources: the Sarbanes-Oxley Act and three corporate governance codes published after the Act became effective – the Report of the Task Force on Corporate Responsibility of the American Bar Association; the Findings and Recommendations of the Commission on Public Trust and Private Enterprise of The Conference Board, and Principles of Corporate Governance of The Business Roundtable.⁹

Those sources address corporate governance in a business context, not in a

nonprofit sector environment. This commentary identifies significant modifications to the principles made to adapt them to nonprofit corporations. As it turns out, the principles fit without much difficulty, which is consistent with the underlying reality that fundamental corporate governance standards are much the same for nonprofit corporations as for business corporations.

Principles 1 and 2

The laws of every state contain fiduciary duties, the twin duties of care and loyalty, applicable to directors of nonprofit corporations. But the meaning of the language used to define the duty of care is far from self-revealing. For example, California's defines the duty of care as the duty to act in good faith "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."¹⁰

The search for clearer guidance is unending. A recent version is offered by the American Bar Association. Principles 1 and 2 are derived from the corporate governance practices recommended by the Task Force on Corporate Responsibility of the American Bar Association and adopted by the ABA in August, 2003.

The Task Force identifies as a major board problem "a culture of passivity with respect to senior executive officers, in which those officers are not subject to meaningful director oversight The goal of the policies and practices recommended in this Report will only be fully achieved if . . . directors abandon the passive role many have been content to play, and replace it with a new culture stressing constructive skepticism and an active, independent oversight role."¹¹

Concern with the culture of board passivity prompts the emphasis on an active board. The ABA standard does not call for micromanagement by the board, but it does provide that the director with knowledge relevant to the board's responsibilities may not sit by quietly and withhold that information from the board; the director has an affirmative obligation to disclose relevant information to the board (Principle 2). The directors "must engage in active, independent and informed oversight" (Principle 1).

Board passivity is not limited to business corporations. Directors of nonprofit corporations have also been faulted for reluctance to ask key questions and to participate actively in board meetings.¹²

Principles 3 through 5

The notion that every board of directors should have a nomination/governance committee is widespread in recommended practice codes. A common feature is that the committee be independent in the sense that the directors serving on that committee are not part of the management team and are not compensated by the corporation for services rendered to it, although they may receive reasonable fees as a director.¹³

Principle 4 reflects another consensus in the recommended practice codes of corporate governance. A requirement for annual evaluations of the executive director appears frequently in these codes. An annual evaluation requirement for directors appears less often. What is new here is the proposed three-tier evaluation at the board level. Annual evaluation is recommended not only for each director, but for each committee, and for the board of directors as a whole, reflecting a concern that the result of individual director evaluations may reveal little about how the directors perform in relevant groups.¹⁴

Principle 5 reflects a final common theme in recommended practice codes: a recognition that a strong ethical standard should be set by a "tone at the top."¹⁵

Principle 6

Only a few states currently require annual audits of nonprofit corporations. But that is changing. Some states have proposed mandatory audits for nonprofit organizations with assets or gross revenues over \$250,000. In other states audits are required only of larger nonprofits, those with assets of \$3 million or gross annual revenues of \$1 million. Below a certain size, the nonprofit corporation may not be able to afford the costs of an annual audit. Nevertheless nonprofit corporations with substantial assets or annual revenue should anticipate that mandatory annual audits will be required.

The Sarbanes-Oxley Act requires that the board of directors have an audit committee composed entirely of directors who are independent in the sense that they are not part of the management team and they are not compensated for services rendered to the corporation, apart from fees for board service.

Similar requirements are likely to be imposed by state law on nonprofit corporations. Legislation proposed (but withdrawn, see footnote 5) by the New York Attorney General would have required nonprofit boards to designate an audit committee if the organization has gross revenues over \$250,000. Not only may the directors on the audit committee not be paid for services to the corporation, they may not have participated in any interested party transactions in the last year.¹⁶

California's Nonprofit Integrity Act of 2004 requires annual financial audits of charities registered with the Attorney General with gross revenues of \$2 million or more in any year. Audit committees and public disclosure of those statements are also required. For more on that Act see Silk and Fei, "State SOX: Explanation of California's Nonprofit Integrity Act of 2004 (SB 1262)" in 46 *Exempt Organization Tax Review* p.35 (January, 2004.)

Principle 7

The Sarbanes-Oxley Act requires the chief executive and chief financial officer to certify that the officer has reviewed the financial statements, that they contain no untrue statement or omission of material fact, and that they fairly present the financial condition and operations of the company. Willful false certification is subject to criminal sanctions.

Current law requires IRS Form 990 and Form 990-PF, the annual information returns filed by public charities and private foundations, to be signed by an officer. Those information returns are signed with a declaration under penalty of perjury that the officer has examined the return and accompanying schedules and that they are "true, correct, and complete." The Internal Revenue Code contains its own perjury and false statement statute making willful violations a felony. IRC § 7296(1).

The IRS has a wide choice of laws to select from to enforce the making of true statements in connection with tax returns. In this new climate of compliance, nonprofit corporations would be well-advised to follow the sound advice given by Independent Sector that both the "CEO and the CFO should review the Form 990 or 990-PF before it is submitted to ensure that it is accurate, complete, and filed on time."¹⁷

Principle 8

The imposition by the Sarbanes-Oxley Act of regulations and restrictions on accountants has received extensive publicity. Less fanfare has accompanied a new rule imposed on lawyers. The Act seeks to improve compliance by requiring lawyers to "climb the ladder" within the client company. If the lawyer is aware of evidence of material violations of securities law or breach of fiduciary duty by the company or any agent, the attorney must report that evidence to the chief legal

officer or chief executive officer. If that person does not respond appropriately, then the attorney must report to the audit committee or the board of directors.

The ethical rules of the legal profession are moving in a similar direction. California has a permissive reporting-up rule. Under California's Rule of Professional Conduct 3-600(B), when a lawyer learns of wrongdoing by a corporate client, the lawyer may refer the matter "to the next higher authority in the organization, including, if warranted by the seriousness of the matter, to the highest internal authority." The ABA recently enacted a "climb the ladder" rule that is mandatory when applicable. In 2003, the ABA completely revamped Model Rule 1.13, which now provides that when an attorney learns of wrongdoing that is likely to result in substantial injury to the corporation, the attorney "shall refer" the matter to the highest authority in the corporation, the board of directors.

In the nonprofit sector, these trends in the law are likely to result in an increase in compliance discussions, initiated by the attorney, with the executive director and with the board of directors.

Principles 9 and 10

The Sarbanes-Oxley Act also adds two criminal offenses to federal law. Anyone who alters or destroys a document with the intent to obstruct a federal investigation is guilty of felony; so, too, is a person who discharges, demotes, or harasses an employee for providing true information to a federal law enforcement officer.

The scope of these criminal offenses extends to individuals in nonprofit corporations as well as businesses and would apply in connection with IRS audits or other federal investigations of tax-exempt organizations.

To the extent that state laws do not already criminalize similar conduct in connection with state law enforcement investigations, we are likely to see the adoption of such laws at the state level.

Accordingly, a nonprofit corporation would be well-advised to elevate awareness of these changes within the organization by adopting written policies setting forth standards for document integrity and retention and by making plain that employees, without fear of retribution, are encouraged to alert management and the board to ethical issues and potential violations of law.

Footnotes to TEN EMERGING PRINCIPLES OF GOVERNANCE OF NONPROFIT CORPORATIONS

¹ Leo E. Strine, Jr. "Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle," 57 *The Business Lawyer* 1372 (August 2002); E. Norman Veasey, "Should Corporation Law Inform Aspirations for Good Corporate Governance Practices – Or Vice Versa?" 149 *U. Pa. R. Rev.* 2179 (June, 2001).

² "Findings and Recommendations: Part 2 Corporate Governance," Commission on Public Trust and Private Enterprise (*The Conference Board*, 2003); "Principles of Corporate Governance," (*The Business Roundtable*, 2002); "Corporate Governance Practices," adopted by the American Bar Association (2003).

³ See e.g., Margaret Gibelman and Sheldon R. Gelman, "Very Public Scandals: An Analysis of How and Why Nongovernmental Organizations Get in Trouble" [paper presented at the International Society for Third-Sector Research at the Fourth International Conference, Dublin, Ireland, July 7, 2000]; Marion R. Fremont-Smith and Andras Kosaras, "Wrongoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002," 42 *Exempt Organization Tax Review* 25 (October, 2003).

⁴ The Sarbanes Oxley Act, enacted on July 30, 2002, imposes on publicly traded companies and their accountants and lawyers new requirements designed to improve corporate governance and thereby rebuild public trust in the corporate sector.

⁵ In January 2003, Attorney General Eliot Spitzer of New York announced the introduction of legislation to protect nonprofit corporations against financial fraud by adopting reforms similar to those enacted by Sarbanes-Oxley. Attorney General's Legislative Program Bill # 02-03. In California, Attorney General Lockyer's staff developed a legislative proposal which emerged as SB 1262, introduced by Senator Sher on February 13, 2004. That bill, in amended form, was signed into law on September 29, 2004, as California's Nonprofit Integrity Act of 2004. Subsequently, Spitzer's office issued a press release announcing it was withdrawing support for similar legislation in New York because education and training were more suitable than new legislation for charitable organizations.

⁶ It is settled law in California and elsewhere that evidence of the custom or practice of others similarly situated is admissible in court on the issues of due care or negligence. See *Bullis v. Security Pac. Nat. Bank*, 21 C.3d 801,809 (1978); Prosser & Keaton, Torts (5th edition) §33.

⁷ In a recent seminal article, the authors argue that "the behavioral phenomena of internalized trust and trustworthiness play important roles in discouraging opportunistic behavior among corporate participants." They identify three sources of trust and trustworthiness: (1) enforcement of laws, (2) market sanctions (combining fear of retaliation, reputational loss, and social sanctions), and (3) internalized trust (an internalized belief or taste or preference for behaving trustworthily). Margaret M. Blair and Lynn A. Stout, *Symposium Norms & Corporate Law: Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 *U. Pa. L. Rev.* 1735 (June, 2001).

⁸ Enron's corporate culture of deceit amounted to an in-house joke, as captured by a song "Balance Sheet Blues," which circulated within the company in 1998: "They call us innovators/We got to please the rater/Don't feed us to the 'gators/We got the balance sheet blues." Jeffrey Toobin, "End Run At Enron," *New Yorker*, p. 49, 55 (October 27, 2003).

⁹ The four documents are available at the following websites – www.findlaw.com; www.abanet.org; www.conference-board.org; and www.brt.org.

¹⁰ The definition of the duty of care for directors of business corporations and for directors of nonprofit corporations is often the same or similar. Compare Cal. Corp. Code §§ 309(a) and 5231(a); compare Revised Nonprofit Corporation Act §8.30(a) and Model Business Corporation Act §8.30 (a); compare New York N-PCL §717 and BCL §717; see also Bjorklund, Fishman, and Kurtz, New York Nonprofit Law and Practice with Tax Analysis §11.2(b).

¹¹ Report of the Task Force on Corporate Responsibility of the ABA, pp. 10-11 (2003).

¹² See e.g., Chait, Holland and Taylor, *Improving the Performance of Governing Boards* p. 4 (1996).

¹³ See *Principles of Corporate Governance*, p.20 (Business Roundtable); *Corporate Governance: Principles, Recommendations and Specific Best Practice Suggestions*, p. 10 (Conference Board).

¹⁴ Business Roundtable, p. 27; Conference Board, p. 10.

¹⁵ Business Roundtable, p. 9; Conference Board, p. 25.

¹⁶ *New York Attorney General's Legislative Program, Program Bill # 02-03* (January 21, 2003).

¹⁷ *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* p. 7 (Independent Sector and BoardSource, 2003).

GUIDES TO A SAFE HARBOR

What can we learn from this analysis of emerging principles in nonprofit governance that may be of practical use to us? The most valuable teachings, I suggest, are not about the particular principles themselves, which will change over time, but about underlying truths. By following these guides, the Board of Directors, officers, staff, and volunteers of every charitable corporation will arrive at the safest harbor.

1. Increasingly, charities are expected by the public to take the high road.
2. It is no longer sufficient for a charitable organization merely to comply with the letter of the law or even the spirit of the law. The charity must go beyond the law. The public now looks to charities to act as moral agents.
3. Charitable organizations with the greatest likelihood of satisfying emerging public expectations will be those that take all measures necessary to ensure that the conduct of its directors, officers, and employees reflects the highest ethical standards appropriate to the organizations' structure and mission.
4. To settle for less is to run the risks that the charitable organization's reputation for integrity will be weakened, its respect by the community will be diminished, and its ability to fulfill its mission will be imperiled.

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Summary

THREE CHECKLIST FOR ACCOUNTABILITY

Strengthen your organization's transparency and governance

Building an organization committed to the highest ethical standards demands more than just following the law: it also requires fostering practices that create an environment of transparency, accountability and integrity. The steps listed here will help every charitable organization reassure its stakeholders of its commitment to upholding the public trust vital to earning support and fulfilling its mission. Creating an accountable organization is an ongoing process. Board and staff members should review recommended practices regularly, and adjust their rules, methods and communications as needed.

Fortunately, no one has to start this work from scratch. There are many resources available as models, and we encourage you to share your policies and practices with colleagues. INDEPENDENT SECTOR recommends that each charitable organization take the following steps to demonstrate accountability. Adapt them to fit your unique circumstances, and check back for updates as the checklist is expanded.

1 Develop a Culture of Accountability and Transparency

Rules, standards, and practices are far more effective when the people they affect understand them, know why they are important, and embrace them. Teach new employees, volunteers, and board members about your principles, and give those with more experience refreshers and updates. Use your website, intranet, and other internal communications vehicles to share examples of good behavior and policies.

2 Adopt a Statement of Values and Code of Ethics

This document describes the ethical principles that an organization's staff, board and volunteers agree to follow, and includes a statement of values articulating the principles it is committed to uphold. An indispensable part of an accountable organization, a statement of values and code of ethics should be approved by the board of directors, included in staff and board orientations, and available to the public on the organization's website.

3 Adopt a Conflict of Interest Policy

Adopt and enforce a conflict of interest policy tailored to your organization's specific needs and consistent with laws in your state. Few actions will undermine the credibility of a charitable organization faster than having its tax-exempt funds not used exclusively for charitable purposes. Adhering to a well-defined conflict of interest policy will help preempt even the perception that funds are being used for personal gain by the managers or board members. Many states have laws that govern conflict of interest situations and all organizations should consult their state laws to ensure that their conflict of interest policy affords them the necessary protections.

4 Ensure that the Board of Directors Understands and Can Fulfill Its Financial Responsibilities

The board has the legal—as well as the ethical—responsibility of ensuring the exclusive and effective use of all assets for charitable purposes. As part of this obligation, the board or appropriate board committee should review and approve all financial statements for completeness and accuracy. To perform this function

effectively, the board should include individuals with financial literacy or adopt other mechanisms for drawing on independent financial expertise.

5 Conduct Independent Financial Reviews, Particularly Audits

Charitable organizations need to have independent reviews of their financial procedures, controls, and policies in order to provide strong financial safeguards. Charitable organizations that are required to file a Form 990 or 990-PF and that have average annual revenues of \$1 million or more should have an audit conducted of their financial statements and operations. These statements should be made available for public inspection. Charitable organizations that are required to file a Form 990 or 990-PF and that have at least \$250,000 and under \$1 million in total annual revenues should have their financial statements reviewed by an independent public accountant. Organizations with less than \$250,000 in annual revenues should consider periodically obtaining a review of financial statements or other means of independently verifying financial statements and controls.

6 Ensure the Accuracy of and Make Public Your Organization's Form 990

The IRS Form 990, Form 990-EZ, and Form 990-PF is one way that organizations share information about their finances and operations with charity regulators and the public. To be effective, however, its information must be complete, accurate and publicly available. Be sure to have your Form reviewed by your board and signed by your CEO or CFO. Support efforts to improve the quality and timeliness of information about nonprofits by filing your Form electronically with the IRS. And, finally, be sure to post it on your website.

7 Be Transparent

Your donors, volunteers, and staff will have much more confidence in your organization's work if they know how you're doing it. Use your website to share documents that provide information about your finances, operations, governance, and impact.

8 Establish and Support a Policy on Reporting Suspected Misconduct or Malfeasance ("Whistleblower Protection Policy")

In order to protect the credibility of your organization, each organization needs policies and procedures that encourage individuals to come forward as soon as possible with credible information on illegal practices or violations of adopted policies. Employees and volunteers who identify misbehavior must feel safe to report it. Not only is this good practice, but the Sarbanes-Oxley Act requires all entities, including nonprofit organizations, to protect whistleblowers and levies criminal penalties for actions taken in retaliation against whistleblowers.

9 Remain Current with the Law

Make sure that a board member, member of staff, consultant or volunteer is designated to keep up to date with the law. Ensure that your organization fully complies with all existing laws governing charitable organizations.

Test Your Accountability IQ

Does Your Organization:

- Hold staff and board trainings on ethics or take other measures to foster a culture of accountability and transparency?
- Have a code of ethics and statement of values and post it on your website?
- Follow a conflict of interest policy and post it on your website?
- Have board members with financial expertise?
- Have its financial statements independently audited?
- Have board members review financial statements, including the Form 990?
- Have your CEO or CFO sign the Form 990?
- File your Form 990 electronically?
- Post your Form 990 on your website?
- Post your policies, financial information, and information on programs results on your website?
- Have a whistleblower policy?
- Take steps to remain current with the law?

Give your organization one point for every yes. If your organization scores:

12: Great, keep it up and pass along your success stories and model policies for others to learn from.

9–11: Good, but there's room for improvement.

6–8: You've indicated a commitment to accountability but need to advance beyond the basics.

0–5: Time to get serious about accountability. Engage your board, staff, and volunteers quickly to help make the needed changes.

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For a copy of the complete Checklist see www.independentsector.org.

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