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# Ethics and the Board -- Emerging Rules for Association Directors

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## I. What is behind the recent pressures on non-profits to enhance their protections against conflicts of interest dn other possible ethical breaches?

### A. What is the Sarbanes-Oxley Act and should non-profits be concerned about it?

The American Competitiveness and Corporate Accountability Act of 2002 (also referred to as "Sarbanes-Oxley" after its principal authors or more familiarly as "SOX") was enacted on July 30, 2002, to prevent the continued erosion of investor confidence in the stock market and to prevent the recurrence of such scandals as Enron, WorldCom, Global Crossing, Adelphia, and Tyco. The act imposes new governance standards on public companies, broadening the role that board members play in monitoring financial and auditing procedures.

### B. Does the Act have any direct impact upon non-profits?

1. Two provisions of the Act specifically apply to all companies, non-profits as well as for profits. These criminal restrictions impose new burdens on non-profits and their principals.

a. The Act protects whistleblowers by making it a crime to retaliate against any person providing truthful information to a law enforcement officer regarding the commission or possible commission of a federal offense.

b. The Act makes it a crime to destroy litigation-related documents, specifically to alter, cover up, falsify, or destroy any document, or persuade someone else to do so, to prevents its use in an official proceeding, e.g., court action, regulatory investigation, or bankruptcy proceeding.

2. When it was initially enacted, many people considered several parallels between public companies and non-profits and expected that a comparable code of behavior for non-profits would follow.

a. Public companies and non-profits must appeal to the general populace for a significant part of their financial support, for profits in the form of equity and debt investments and non-profits in the form of contributions.

b. Public companies and non-profits are already heavily regulated at the national level, and national legislators feel a stewardship towards both. The SEC and the IRS have responsibility for determining in considerable detail how each will operate, with respect to capital-raising in the case of public companies and with respect to expenditures in the case of non-profits.

c. The public confidence in both institutions had been shaken. Scandals involving non-profits had included those at United Way, Covenant House, Adelphi University, and even the Red Cross in its handling of donations after September 11.

II. Have any of the additional Sarbanes-Oxley standards been imposed on non-profits?

A. The Congress initially appeared to be headed for an expansion of the Act's coverage to include non-profits.

1. In June 2004, the Senate Finance Committee announced the first of what were to be a series of hearings on protecting charities from exploitation. Following the first hearing, the Chairman of the Committee, Senator Charles Grassley, spoke in florid language about the "unscrupulous behavior" that had been uncovered: "It's obvious from the abuses we see that there's been no check on charities. Big money, tax-free, and no oversight have created a cesspool in too many cases.... We see powerful insiders using the assets of charities to line their own pockets instead of to help the needy. Donations and assets are being used for things like private jets and European vacations." He announced, "I hope to introduce legislative reforms this fall, and maybe earlier for some provisions."

2. A discussion draft of proposals released by the Finance Committee in connection with the hearings included such suggested limitations as restricting reimbursements for travel to the applicable U.S. government rate or an alternative created for non-profits with excessive payments punished by a 10% excise tax, requiring that the annual information return on Form 990 be subject to review by an independent auditor for conformity to established filing standards, mandating that, in keeping with the Sarbanes-Oxley standards, a new auditor be hired every five years, forcing greater disclosure of a non-profit’s relations with affiliated exempt and non-exempt organizations, investments, and material changes in activities, operations, or structure, and even specifying the number of Board members (no fewer than three or more than 15).

B. Much pressure for statutory changes has been abated.

1. Legislators realized that the expense that would be imposed on non-profits

would be prohibitive. They realized that of 3 million tax-exempts in the United States, some 1.3 million are charities, and some 79% of those operate on budgets of less than $100,000.

2. Imposing onerous standards on largely volunteer directors would simply have them resign and leave even greater authority in the hands of the paid executives.

3. State regulators were already monitoring abuses with some effectiveness. Only two weeks ago, for example, it was reported that the New York attorney general had acted to bar two executives from continuing to serve a large non-profit and had required restitution by one of $132,000. This followed a 15-month investigation in which the principal finding was a lack of financial oversight by the organization's governing bodies. In 2002, that office forced three board members of another non-profit to give up their seats and return $1.5 million.

4. The IRS had only recently promulgated final regulations imposing stiff excise taxes on the so-called excess benefit transactions of non-profit organizations.

5. Groups such as the Independent Sector undertook an investigation of non-profit organizations and developed a narrower set of recommendations including many calling simply for voluntary adoption by the organizations themselves.

C. Several reforms may well be enacted.

1. The likeliest reforms to become law are those included in the Tax Relief Act of 2005 that has passed the House and Senate and that may go to a conference committee next week. Reforms applicable to charitable organizations are included only in the Senate bill, however. The few with general applicability to non-profits include authorization to the IRS to disclose information regarding enforcement actions to state officials and a doubling of the penalties for self-dealing by charitable foundations and for breach of the excess benefits rules applicable to other (c)(3) and (c)(4) organizations.

2. Other Sarbanes-Oxley requirements are unlikely to be imposed on non-profits, at least those with revenues below a certain substantial size, including a requirement that each member of an organization's audit committee be a member of the board of directors and be independent, a requirement that the organization disclose whether the audit committee contains at least one financial expert, a mandate that the lead and reviewing partner of the auditing firm rotate off audit every five years, a prohibition on having the auditing firm provide many non-audit functions, a need for certifications by the CEO and CFO of the financial statements, and a requirement of disclosure of internal control mechanisms, corrections to past financial statements, and material off-balance sheet transactions.

II. What are the IRS excess benefits rules?

A. IRS rules bar any benefit to organization insiders. Section 501(c)(3) of the Code

explicitly provides that "no part of the net earnings of [the charity may] inure[] to the benefit of any private shareholder or individual." This language has been interpreted to mean that a charity is not to allow its earnings unreasonably to benefit an insider. United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1174 (7th Cir. 1999) . An insider, for this purpose, is any person or entity occupying a position equivalent to that of an "owner or manager." Id. at 1176. Prior to 1996, however, the IRS could punish any violation of this ban only by revoking an organization's tax exempt status.

B. Section 4958 of the Code created what are called "intermediate sanctions" for private inurement. The rules apply to so-called "disqualified persons, " defined as individuals who are "in a position exercise substantial influence" over to Sec. 501(c)(3) and Sec. 501(c)(4) organizations or were in such position at any time during the five years preceding the transaction. Also disqualified are relatives of and entities controlled by a disqualified person.

C. Excess benefits subject to excise tax are benefits that exceed what "would ordinarily be paid for like services by like enterprises under like circumstances." Benefits include salaries and compensation or any other payments made or benefits conferred.

D. Three separate taxes are imposed on excess-benefit transactions: A first-tier tax on the disqualified person equal to 25% of the excess benefit, a 10% first-tier tax on managers, and a 200% second-tier tax on the disqualified person for failure to correct.

E. To avoid these sanctions, a non-profit should try to identify all disqualified person and make certain none directly or indirectly receives unreasonable compensation. The proposed rules give non-profits a presumptive safe harbor. The IRS will consider compensation presumptively reasonable if an organization meets these prescribed procedural requirements when making compensation decisions:

1. Members of the governing body or committee approving the arrangement have no conflicts of interest with respect to the transaction,

2. The governing body obtains and relies on appropriate comparability or fair market value data, and

3. The governing body adequately and contemporaneously documents the basis for its determination.

II. What does Maryland state law have to contribute towards protecting non-profits from conflict transactions?

A. The Maryland general corporation law imposes a standard of care on directors of all corporations, not only non-stock (non-profit) corporations. Corp. & Assoc. Art. § 2-405.1.

1. A director of a Maryland corporation must perform his or her duties in good faith (honestly), in a manner he or she reasonably believes to be in the best interests of the corporation (loyally), and with the care that an ordinarily prudent person in a like position would use under similar circumstances (carefully).

2. A direct can rely on information provided by employees, by outside advisors, and by fellow directors, if the director's reliance is reasonable. Such reliance will be reasonable when those providing the information are acting within the scope of their responsibilities and competence, and the direct has no reason to believe that reliance is unwarranted.

3. Directors enjoy a presumption that they act properly. The burden is on a challenger to prove otherwise.

4. A director's alleged violation of this standard can be questioned only by the corporation or someone acting in the corporation's name. In other wise, any recovery for breach can go only to the corporation.

B. The Maryland general corporation law bars membership on a board committee to anyone but directors. Corp. & Assoc. Art. § 2-411.

C. Maryland law bars a corporation from limiting the liability to the corporation of directors or officers who are found in an adjudication to have engaged in an action or inaction that resulted from active and deliberate dishonesty. Courts & Jud. Proc. § 5-418. It also precludes indemnification by a corporation if an act or omission was committed in bad faith or was the result of active and deliberate dishonesty or the director actually received an improper personal benefit. Corp. & Assoc. Art. § 2-418.

D. Under Maryland law, if a director engages in a transaction with a corporation, the transaction is not void or even voidable, notwithstanding the director's presence at the approval of the transaction or vote in favor of such approval, if the approval is given after the interest of the director is disclosed and the approval did not require the vote of the interested director, or the transaction is fair and reasonable to the corporation. Corp. & Assoc. Art. § 2-419.

III. Apart from those actions mandated by law, certain reforms should be undertaken by all non-profits in the interest of giving comfort to donors and beneficiaries and contributing to a climate of sound ethics that will discourage government regulation.

A. Non-profits should create an audit committee (if they do not already have one) and make certain it is active. In a smaller organization, the audit committee may be combined with the finance committee.

B. Non-profits should adopt and make public a codes of responsibilities for corporate directors. It should set forth the core values of the organization and alert the directors to what is

expected of them.

C. Non-profits should adopt and make public a conflict of interest policy covering not only directors but also officers, employees, and major donors. It should include a mechanism for resolving conflicts at different levels of decision-making responsibility and may incorporate, if not otherwise established, protections for employees who report abuses.

D. Non-profits should adopt a record retention policy. It should assure that corporate and organizational records and year end statements are kept permanently, bank and investment statements and IRS filings and back-up are kept for seven years, and periodic treasurer's reports are kept for three years.