



# Adopting the Best Policies

## Sarbanes-Oxley Includes Nonprofit Legal Accountability

### HIGHER STANDARDS

#### Nonprofits Are Being Watched

In a 2005 comment on the California's Nonprofit Integrity Act of 2004 (NIA)—which was that state's version of Sarbanes-Oxley aimed at the nonprofit sector—attorney Thomas Silk noted:

How can the honest director or officer protect herself or himself from becoming engulfed and confused by the “swirl of change” in standards of nonprofit governance? In this unsettled legal environment, charitable organizations and their directors, officers, and staff are likely to reach the safest harbor if they remain mindful of these principles:

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 their 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.

— Thomas Silk, “Rational Exuberance: An Exploration of the Adaptation by California's Charitable Sector to Changing Governance Standards: Notes from the Field,” Tax Analysts Exempt Organizations Text, June 22, 2005.

When Congress passed the Sarbanes-Oxley Act of 2002<sup>1</sup>, it intended to restore public trust in America's corporate leaders, a trust that had been shattered by highly visible scandals at Enron, Arthur Andersen, Global Crossing, and other major for-profit corporations.

Most nonprofits breathed a sigh of relief that its reforms appeared to focus exclusively on for-profit corporations and had little to do with them. But our sector has suffered its own loss of confidence<sup>2</sup>, and it is only a matter of time before the Sarbanes-Oxley requirements filter their way into our nonprofit organizations.

Sarbanes-Oxley represents a fundamental shift in enforcement methodologies. It seeks to ensure that corporations make good financial decisions by mandating certain practices: establishing responsible review structures, making financial information more easily available, and providing sanctions against those who intentionally misstate financial information, hide important transactions, or engage in self-dealing to the detriment of the company and its shareholders.

There are only two provisions in Sarbanes-Oxley that directly and specifically affect nonprofits. However, there are a number of changes in for-profit financial reporting requirements that are making their way into the nonprofit sector. And, like ripples on a pond, these changes are likely to spread much further than one

might expect—and to bring significant changes in our sector as well.

California, as usual, has led the way with its own state legislation, the Nonprofit Integrity Act of 2004. See the sidebar for comment made in the nonprofit bar at the time, while one of the comments made then is worth repeating here:

“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.”

Let’s look at some aspects of the Sarbanes-Oxley Act and how it directly affects your operations.

**Whistle-Blower Protection.** Sarbanes-Oxley provides new protections for whistle-blowers and criminal penalties for actions taken in retaliation against whistle-blowers—those who report suspected illegal activities in the organization. It is illegal for *any* corporate

entity (nonprofit or for-profit) to punish a whistle-blower in any manner.

*Recommendations for Nonprofit Organizations:* Develop, adopt, and disclose a formal process within your organization to deal with complaints and prevent retaliation. The process should make it clear that you take employee complaints seriously, and that you intend staff leadership to investigate the situation thoroughly and fix any problems they find. If the investigators

## GUIDING LEGAL PRINCIPLES

There are 10 general principles of corporate governance emerging from the Sarbanes-Oxley reforms which may be worthy of consideration for the governance of nonprofit organizations. This list is from *Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley*, by the ABA Coordinating Committee on Nonprofit Governance.

**PRINCIPLE 1 Role of Board.** The organization’s governing board should oversee the operations of the organization in such manner as will assure effective and ethical management.

**PRINCIPLE 2 Importance of Independent Directors.** The independent and nonmanagement board members are an organizational resource that should be used to assure the exercise of independent judgment in key committees and general board decisionmaking.

**PRINCIPLE 3 Audit Committee.** An organization with significant financial resources should have an audit committee composed solely of independent directors, which should assure the independence of the organization(s) financial auditors, review the organization(s) critical accounting policies and decisions and the adequacy of its internal control systems, and oversee the accuracy of its financial statements and reports.

**PRINCIPLE 4 Governance and Nominating Committees.** An organization should have one or more committees, composed solely of independent directors, that focus on core governance and board composition issues, including: the governing documents of the organization and the board; the criteria, evaluation, and nomination of directors; the appropriateness of board size, leadership, composition, and committee structure; and codes of ethical conduct.

**PRINCIPLE 5 Compensation Committee.** An organization should have a committee composed solely of independent directors that determines the compensation of the chief executive officer and determines or reviews the compensation of other executive officers, and assures that compensation decisions are tied to the executives’ actual performance in meeting predetermined goals and objectives.

**PRINCIPLE 6 Disclosure and Integrity of Institutional Information.** Disclosures made by an organization regarding its assets, activities, liabilities, and results of operations should be accurate and complete, and include all material information. Financial and other information should fairly reflect the condition of the organization, and be presented in a manner that promotes rather than obscures understanding. CEOs and CFOs should be able to certify the accuracy of financial and other disclosures, and the adequacy of their organizations’ internal controls.

**PRINCIPLE 7 Ethics and Business Conduct Codes.** An organization should adopt and implement ethics and business conduct codes applicable to directors, senior management, agents, and employees that reflect a commitment to operating in the best interests of the organization and in compliance with applicable law, ethical business standards, and the organization(s) governing documents.

**PRINCIPLE 8 Executive and Director Compensation.** Executives (and directors if appropriate) should be compensated fairly and in a manner that reflects their contribution to the organization. Such compensation should not include loans, but may include incentives that correspond to success or failure in meeting performance goals.

**PRINCIPLE 9 Monitoring Compliance and Investigating Complaints.** An organization should have procedures for receiving, investigating, and taking appropriate action regarding fraud or noncompliance with law or organization policy, and should protect whistleblowers against retaliation.

**PRINCIPLE 10 Document Destruction and Retention.** An organization should have document retention policies that comply with applicable laws and be implemented in a manner that does not result in the destruction of documents that may be relevant to an actual or anticipated legal proceeding or governmental investigation.

decide that no action is necessary, your policy should require that they provide written justification as to why corrections are not needed.

**Document Destruction.** Sarbanes-Oxley makes it a crime for *any* corporate entity (nonprofit or for-profit) to alter, cover up, falsify, or destroy any document (or persuade someone else to do so) to prevent its use in an official proceeding (*e.g.*, federal investigation or bankruptcy proceedings). The act turns intentional document destruction into a process that must be monitored, justified, and carefully administered.

**Recommendations for Nonprofit Organizations:** Develop a written, mandatory document retention and periodic destruction policy that will provide clear guidelines for approved disposal of your organization's many documents. The guidelines should address the handling of paper files, electronic files, and voicemail. Remember that electronic documents and voicemail messages have the same status as paper files in litigation-related cases. A key element of any such policy must provide that, if an

official investigation is underway or even suspected, your staff must stop any document purging in order to avoid criminal obstruction charges.

**Governance and Operations.** There are a number of ways that Sarbanes-Oxley mandates changes in a for-profit's governance and operational activities. I will not go into them here as most have been widely publicized and will not be new to you. These provisions are not imposed on nonprofit organizations.

However, good governance often means that you get out ahead of governmental mandates, and the fundraising world is asserting ever-more pressure on nonprofits to prove by their actions that they understand and endorse best practice in this area.

The American Bar Association's Coordinating Committee on Nonprofit Governance developed 10 principles that incorporate Sarbanes-Oxley "understandings." They are included here in their entirety for your convenience. I encourage you to give this article to your board governance chair, and assist them in getting these principles implemented to the greatest extent possible. ▲

#### Endnotes

1. Public Law 107-204, 116 Stat 745 (2002). The Act established a number of provisions in the Exchange Act and its regulations.
2. Most notably in the spending excesses of executives at the United Way, the self-dealing by directors at The Nature Conservancy, and the Ponzi schemes foisted by founders of the Foundation for New Era Philanthropy and the Baptist Foundation of Arizona.



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