

New Developments Spotlight: Problematic Governance Practices

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Recent regulatory developments better position health lawyers to advise their nonprofit clients on the risks of certain types of governance practices. For example, the New Jersey Attorney General recently settled its wide-ranging civil complaint against nonprofit Stevens Institute of Technology, its President, and Board Chair.¹ The settlement contains a series of governance reforms that the Attorney General refers to as “best in class.” In addition, the Internal Revenue Service (IRS) recently released an informative set of guidelines to be applied by its agents in the course of evaluating the governance practices of tax-exempt organizations under examination.²

Collectively, these developments provide tangible evidence of what charity regulators may consider to be problematic governance practices, together with valuable suggestions on those practices that may be viewed favorably by regulators. The developments also serve to underscore the continued interest of federal and state charity officials in exercising oversight over nonprofit governance. In particular, their release is timely given the expanded disclosure of nonprofit corporate governance practices on Part VI of the new Form 990. Charities on a calendar year have already filed their first Form 990 with the new governance questions, and charities with a June 30 year-end have an April 15, 2010 deadline, including all extensions, to file their first new Form 990, meaning that governance will continue to be in the spotlight.

I. Stevens Institute Settlement

The civil complaint filed last September by New Jersey Attorney General Anne Millgram,³ alleging that nonprofit Stevens Institute of Technology, its President and its Board Chairman mismanaged the nonprofit’s finances and endowment, and excessively compensated its President, and the terms of the January 15, 2009 settlement, provide health lawyers with several valuable corporate governance lessons. The allegations in the complaint and the terms of the settlement illustrate some of the concerns leading to the new IRS examination guidelines.

The overall Stevens controversy reflects (1) the willingness of state officials to challenge board action they perceive as placing charitable assets at risk; (2) the specific type of board conduct that may attract regulatory inquiry; and (3) the breadth of relief (including governance reforms) potentially available to state charity officials to correct problematic practices.

The Stevens case is directly relevant to nonprofit hospitals and health systems because it involved a sophisticated nonprofit corporation recognized as income tax exempt under

Internal Revenue Code (IRC) Section 501(c)(3). Furthermore, the Attorney General acted under the authority of statutes equally applicable to nonprofit healthcare corporations—the state nonprofit corporation act and the Uniform Management of Institutional Funds Act (UMIFA). Indeed, the Attorney General specifically intends that the new governance format is to serve as a model for other nonprofit organizations.

A. Case Background

The Attorney General’s September complaint was the product of a three-year state investigation of the university’s financial practices. The complaint was based upon allegations of breach of multiple fiduciary duties and of UMIFA duty by the President, Board Chair, and other “insider” board members. The allegations included:

- » Regular misstatements of the nonprofit’s financial reports;
- » “Grossly negligent” internal control and accounting practices;
- » Failure to correct related internal control weaknesses despite repeated warnings by the nonprofit’s auditors;
- » Violation of board-approved endowment spending rates;
- » Borrowing without required corporate approval;
- » Invasion of restricted assets and collateralizing endowments;
- » Use of gifts and bequests to satisfy operating expenses;
- » Violating donor-imposed restrictions;
- » Failure to monitor and diversify the organization’s endowment portfolio; and
- » Approving payment of excessive amounts of compensation to the university President.

Specifically, the Attorney General alleged that a small group, consisting of the President, the Board Chair, and two vice-chairs dominated the board and committees. Committees allegedly acted far beyond their authority, did not keep minutes, and did not report to the board. Allegedly, financial statements and auditors’ management letters, which outlined serious control deficiencies, were not provided to the board, the board was misinformed about the reason for the auditing firm’s resignation, and the board was not provided with budgets or reports on the state of the endowments. Further allegations are that the board was told that compensation comparability analyses for the President had been undertaken for several years when they had not been, and that when the studies were at last undertaken, the President pressured the outside consultant to change comparables to make the results more favorable.

B. The Settlement

By the January 15 “Consent Judgment,” Stevens agrees to accept a series of “sweeping” governance changes affecting the composition and structure of its board and committee practices. Further, the President agreed to resign, but will remain compensated consistent with existing employment, consulting, and non-compete periods for set periods of time. Among the most notable of the governance reforms include the following:

- » *Executive Committee.* The Executive Committee is to be reconstituted as solely an advisory body, with no power or authority to act on behalf or in the name of the board.
- » *Full Board Powers.* The full board of directors is to be extended exclusive power and authority to take action on a wide variety of financial, operational, and compliance matters, including certain of those that normally would be exercised by committees with board designated powers.
- » *Audit Committees.* The Audit Committee charter will be revised to provide it with more complete oversight of the nonprofit’s financial affairs. The revised charter will charge the Committee with the responsibility (among other powers) for reviewing the Form 990 and for conducting an annual audit of all expenses of the President and of the other five most highly compensated Stevens employees. The Committee is to engage a professional with appropriate financial expertise to serve as both a trustee and as Committee chair. However, the full board is to meet with the auditor, review the auditor’s management letter, and review the Form 990.
- » *Roles of Chair, Vice Chair.* Neither the Chair, Vice Chair, nor any member of the Executive Committee may serve as the Chair or Vice Chair of any committee or subcommittee (other than the Executive Committee). Further, the President may not serve as a voting member of the board but may participate in board and committee meetings in a non-voting capacity.
- » *Term Limits.* There is to be a maximum 15-year term for the Chairman and Vice Chairman of the board (with a two-year “stand down” provision). In addition, any trustee having served 12 years on the board and having reached the age of 72 will no longer be eligible to serve as a voting member of the board or committee member. The terms of committee members and chairs will be limited to four years (with a two-year “stand down”).
- » *Special Counsel.* A former New Jersey Supreme Court Chief Justice is to be retained as Special Counsel for a two-year period to ensure Stevens’ implementation of the governance reforms, with specified rights and powers. Other consultants are to be retained to address governance, executive compensation, and finance controls.
- » *Other Committee Matters.* New chairs are to be appointed for each of the Audit, Human Resources, Investment, and Nominating and Governance committees. The charters of these committees are to be revised to clarify their responsibilities.

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- » *Executive Compensation.* Special focus will be placed on the role and duties of, and outside advisors to, the Human Resources and Compensation Committee as it relates to the evaluation and compensation of the President.
- » *Transparency.* All financial statements, credit rating agency reports, annual budgets, investment performance, and key governance documents are to be posted on the corporate website.
- » *Loans.* The corporation will no longer extend loans to any officer nor will it act as a guarantor for loans to any officer. It will also assure that the President’s outstanding mortgage to the corporation will be satisfied in full within a certain time period.
- » *Investment and Donor Matters.* In addition to revising the charter of the Investment Committee, the Board shall conduct a limited audit of certain restricted assets, and will adopt both a “Donor’s Bill of Rights” and “Gift Acceptance Policy.”

C. Lessons Learned

The Attorney General describes the new Stevens governance reforms as “best in class.”⁴ The controversy is a reminder to nonprofit hospitals and health systems that state charity officials will take action when certain governance practices are perceived as placing charitable assets at risk. The Stevens case and the recently released IRS Examination Guidelines, described below, provide nonprofit counsel with practical guidance on what may constitute corporate governance “red flags” to regulators. In the Stevens case, some of the red flags and remedies were:

- » Concentration of governance authority in a small group of board members/officers is problematic.
- » Excessive authority exercised by the Executive Committee may inappropriately limit the rights and powers of the full governing board.
- » Compliance with state laws regarding management of institutional funds (e.g., UMIFA or UPMIFA) should be a board priority.

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- » The executive compensation process must include a close evaluation of the appropriateness of comparability data.
- » Audit Committees—and the full board—must demonstrate responsiveness to the Management Letter issued (and other concerns expressed) by the nonprofit’s independent auditor.
- » The nominating committee should consider sensible term limits on board, committee, and chair positions that appropriately balance the value of institutional knowledge with the importance of turnover and fresh, independent perspectives.
- » The concept of a state-appointed “special monitor” or “special counsel” of a nonprofit organization may prove an increasingly accepted option for state charity officials to assure compliance with mandated governance reforms by the nonprofit.

These red flags are reflected as well in the IRS guidelines and other IRS materials on governance.

II. The New IRS Guidelines

The IRS released, on December 9, 2009, a “Governance Check Sheet” to be completed by the agent finishing an examination of a charity, and a supplementary “Guide Sheet” with instructions for completing the Check Sheet. The release of the Check Sheet and the Guide Sheet (together, the “Guidelines”) is the IRS’ fourth step in bringing its scrutiny of charity governance from the general to the concrete.

- » The first step was the 2008 IRS release of recommended general governance practices as now set forth on the IRS website (“Governance and Related Topics – 501(c)(3) Organizations”)⁵ after an initial draft was circulated in 2007. The practices address: “Mission”; “Organizational Documents”; “Governing Body”; “Governance and Management Policies” (including executive compensation, conflicts of interest, investments, and governing body minutes and records); “Financial Statements and Form 990 Reporting”; and “Transparency and Accountability.”
- » The second step was the inclusion of the governance topics addressed in Part VI of the Form 990.
- » The third step was last year’s release of the materials used by the IRS to train its exempt organizations agents in governance issues.⁶ These materials included a combination of outlines and PowerPoint presentations intended to (a) provide context within which nonprofit governance has become such an important area of IRS focus; (b) describe the various governance-related roles of the IRS, state charity officials, and the nonprofit sector itself; (c) emphasize those governance practices the IRS encourages organizations to adopt; and (d) discuss the role of individual IRS personnel as it relates to their review of governance issues. The materials prepared for IRS examinations and headquarters personnel concentrated on Form 990 questions addressing governance, while the materials prepared

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for IRS determination staff concentrated on Form 1023 questions involving governance.

The newly released guidelines expand upon these governance materials by highlighting those practices likely to be viewed with suspicion or concern by the IRS. According to a senior IRS exempt organizations official, the new guidelines will be applied in all future examinations of public charities (including but not limited to hospitals and health systems).⁷ The data generated also will be used to test the accuracy of the IRS’ oft-stated presumption that good governance supports tax compliance.⁸ Further, governance practices identified as having a strong correlation to noncompliance will be used in selecting future examination targets.⁹

These examination guidelines and training materials continue the IRS practice of cooperation and transparency with the EO sector. It also emphasizes the IRS commitment to monitoring the relationship between corporate governance and tax-exemption compliance. The following discussion will concentrate on those portions of the new examination guidelines of greatest significance to nonprofit boards, their governance committees, and general counsel.

A. The Governance Check Sheet

The first portion of the new examination guidelines is a “Governance Check Sheet” (IRS Form 14114), to be used and completed by IRS agents in their examination of IRC Section 501(c)(3) public charities.¹⁰ The Check Sheet incorporates 28 questions, broken down into seven sections, six of them substantive: “Governing Body and Management”; “Compensation”; “Organizational Control”; “Conflict of Interest”; “Financial Oversight”; and “Document Retention.” These sections are consistent with the principal governance issues contained in Part VI of the redesigned Form 990. The Check Sheet is designed as an “on line” application, incorporating “drop down” menus of possible responses without much room to accommodate a narrative response or other description.

B. The Guide Sheet

The second portion of the guidelines is a “Guide Sheet,” intended as a reference to the IRS agent in completing the Check Sheet as it relates to the governance portion of the examination.¹¹ The Guide Sheet incorporates 28 supplemental “prompts” that relate to the individual questions presented on the Check Sheet. The Guide Sheet contains several specific examples of problematic practices and in general is a more valuable resource for both the IRS agent—and the EO counsel than is the Check Sheet.

C. Lessons Learned

The benefit to health lawyers of the combined examination guidelines is three-fold: *first*, they provide “concrete evidence” that can be used to convince an otherwise suspect hospital/health system CEO that the IRS is taking its EO governance initiative to the examination level; *second*, they highlight the governance issues on which the IRS will concentrate in each examination it conducts of a tax-exempt hospital or health system; and *third*, and perhaps most important, they identify with much greater specificity than before those particular governance practices that the IRS is likely to find troubling or problematic. Such “hot button” practices include the following with respect to the year under examination:

- » The articles of incorporation and bylaws fail to contain any information about (1) the composition, duties, qualifications, and voting rights of board members; and (2) the organization’s charitable purposes (Questions 7, 8);
- » Board members are not provided with copies of the organization’s most current articles of incorporation and bylaws (Question 9);
- » The frequency of full board meetings is inadequate given the business of the organization and/or the full board does not meet with the annual frequency prescribed in the bylaws (Questions 11, 12);
- » The “Rebuttable Presumption of Reasonableness” is not regularly applied in approving compensation arrangements for the organization’s officers, directors, trustees, and key employees (Question 13) (which also appeared in the Stevens Institute case);
- » Persons with conflicts of interest participate in executive compensation decisions (Question 13);
- » The board/committee fails to rely on appropriate comparability data in making executive compensation decisions (Question 14) (which also appeared in the Stevens Institute case);
- » The board/committee fails to contemporaneously record (in meeting minutes or other written documents) the reasons underlying particular compensation decisions (Question 15) (which also appeared in the Stevens Institute case);
- » “Horizontal” conflicts; i.e., business and family relationships between voting board members, exist (Question 16);

- » Effective control of the organization rests with a single or select few individuals (Question 17) (which also appeared in the Stevens Institute case);
- » There is no annual conflict-of-interest questionnaire (Question 18);
- » The board fails to adhere to the organizational conflict-of-interest policy (e.g., failure of conflicted board member to recuse himself/herself) (Question 18);
- » Organizational systems or procedures intended to ensure that assets are used properly and consistently with the organization’s mission are absent (Question 19) (which also appeared in the Stevens Institute case);
- » The board is inattentive to organizational financial affairs (e.g., failure to provide board members with written financial reports; the failure of the board to discuss and consider these financial reports) (Question 20) (which also appeared in the Stevens Institute case);
- » The Form 990 is not reviewed pre-filing by the full board or a designated committee (Question 21);
- » Neither the full board nor a designated committee (a) discussed the independent accountant’s report; and (b) reviewed, discussed (and acted on the recommendations contained in) any associated management letter (Question 23) (which also appeared in the Stevens Institute case); and
- » The organization’s document retention and retention policies are inadequate (Questions 24-25).

D. The Significance


It is important to evaluate these examination guidelines in the proper perspective. There is no current suggestion that the IRS intends to elevate problematic governance practices (on their own) to an exemption-level issue. Nevertheless, evidence of such problematic governance practices may contribute to the IRS evaluation of penalties where there are findings of additional organizational abuse.

It is also conceivable that these new governance examination guidelines may be used by state charity officials in support of their own evaluation of charity compliance with state nonprofit law principles, given the degree of cooperation between these officials and the IRS. This is particularly the case as state charity officials, such as in the Stevens Institute case, become more aggressive in their scrutiny of allegedly problematic governance practices.

III. Conclusion

It should be evident to all that the IRS intends to continue its close attention to the corporate governance of charities, including hospitals and health systems. The check sheet is designed to gather information that the IRS can analyze to gain empirical evidence as to a link between good governance and tax compliance. The Stevens Institute case was not specifically focused on tax compliance but the alleged facts of the case would have triggered many unfavorable answers on the Check Sheet. In its description of good governance practices

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for charities, the IRS stated: “If a governing board tolerates a climate of secrecy or neglect, we are concerned that charitable assets are more likely to be diverted to benefit the private interests of insiders at the expense of public and charitable interests.”¹² The IRS can now point to the Stevens Institute case as a poster child for this statement. With the issuance of the check sheet and instructions, the IRS has provided board leadership and counsel with a concrete governance compliance tool that can help exempt hospitals and health systems avoid joining the lineup. 

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Endnotes

- 1 Final Consent Judgment, available at www.nj.gov/oag/newsreleases10/011510-stevens-consent.pdf.
- 2 See www.irs.gov/charities/article/0,,id=216068,00.html; www.irs.gov/pub/irs-tege/governance_check_sheet.pdf; http://www.irs.gov/pub/irs-tege/governance_guide_sheet.pdf.
- 3 *Milgram v. The Trustees of the Stevens Inst. of Tech.* (N.J. Super. Ct., Initial Complaint Sept. 17, 2009), available at www.nj.gov/oag/newsreleases09/pr20090917a-complaint.pdf.
- 4 Attorney General Press Release, Jan. 15, 2010, available at www.nj.gov/oag/newsreleases10/pr20100115b.html.
- 5 www.irs.gov/pub/irs-tege/governance_practices.pdf.
- 6 See www.irs.gov/charities/article/0,,id=208454,00.html.
- 7 See www.irs.gov/charities/article/0,,id=178221,00.html; Simon Brown, *IRS Must Have Info on Exempt Organizations’ Governance to Show Correlation With Compliance, Says Official*, EO TAX TODAY (Jan. 22, 2010).
- 8 *Id.*
- 9 *Id.*
- 10 www.irs.gov/pub/irs-tege/governance_check_sheet.pdf.
- 11 www.irs.gov/pub/irs-tege/governance_guide_sheet.pdf; www.irs.gov/charities/article/0,,id=178221,00.html.
- 12 www.irs.gov/pub/irs-tege/governance_practices.pdf.