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## Corporate Governance

### Key Nonprofit Corporate Law Developments in 2005

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**T**he year 2005 witnessed a series of dramatic and significant developments in nonprofit corporate and charitable trust law, as they affect the control and operation of hospitals and health care systems. This is consistent with a near decade-long trend that has made corporate law a key feasibility consideration for these organizations.

These developments have most significantly affected the following areas: (a) oversight regulation of nonprofit organizations, at both the federal and state levels; (b) corporate responsibility and Sarbanes-Oxley-based compliance; (c) fiduciary standards of conduct; (d) financial performance and disclosure; and (e) business transactions, both external and intra-system.

Furthermore, these developments reflect the continuation of nonprofit corporation law trends that the au-

thors believe counsel should consider as they advise their nonprofit health care clients on transactional, structural and governance matters. These trends include:

- The continued “close scrutiny” by state attorneys general of the business practices of nonprofit health care providers;

- An increasing recognition from a public policy perspective that governance structures of nonprofit organizations must be improved;

- The ongoing pattern of stakeholders using charitable trust laws to seek remedies that would not be available under nonprofit corporation law;

- The willingness of legislators, courts and regulators to hold nonprofit directors accountable for the conduct and performance of the corporations they serve; and

- The expanding influence of third party interest groups with respect to oversight of nonprofit law compliance.

Based upon these trends, our “top ten” list of major nonprofit developments for health care providers in 2005 follows.

- 1. Panel on the Nonprofit Sector Final Report.** The ongoing policy discussion regarding the need for federal oversight over nonprofit governance reached a zenith in 2005 with the release on June 22 of the Final Report by the Panel on the Nonprofit Sector (“the Panel”) to the U.S. Senate Finance Committee. Entitled “Strengthening Transparency, Governance and Accountability of Charitable Organizations,” the Report contains 15 categories of oversight recommendations for the Finance

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Committee's consideration. Specifically, the Report presents over 130 recommendations for Congress, the Internal Revenue Service and individual charitable organizations.<sup>1</sup>

The Panel represents an independent effort by the nonprofit sector to address the recommendations made to the Senate Finance Committee in the Committee's staff report. The Panel was formed by the Independent Sector in October 2004 at the encouragement of the Finance Committee. The role of the Panel is to prepare recommendations for Congress to improve the oversight and governance of exempt organizations. The recommendations of the Panel are, of course, nonbinding upon the Committee, but Chairman Sen. Charles F. Grassley has indicated that the Committee will closely consider the Panel's work as it crafts a related legislative proposal.<sup>2</sup>

The recommendations contained in the Final Report are likely of significance to most nonprofit organizations in that they address many fundamental governance and operational issues. If converted into legislation, the recommendations have great potential for influencing the manner in which nonprofit organizations govern themselves and preserve their federal tax-exempt status. In its recommendations, the Final Report addresses suggestions set forth in the Senate Finance Committee staff legislative discussion draft released in 2004. The topics covered in the Final Report include:

- **Increased Board Oversight.** Nonprofit boards are urged to more clearly understand, and fulfill, their fiduciary obligations to the organization. This can be achieved through the adoption of clear and effective policies and procedures relating to internal audit procedures/committees; conflicts of interest policies, travel policies and whistleblower policies. Governing boards should also periodically review the effectiveness of the governance structure of the organization and the structure, size, composition and independence of its governing board.

- **Increased Transparency.** The IRS is encouraged to revise the Form 990 informational returns for nonprofit charities in order to obtain information that is more useful to the public and which provides greater assistance to regulators.

- **Strengthen Laws.** Congress should enact laws which provide clearer guidelines for donor-advised funds, the popular "Type III" supporting organizations, participation in potentially abusive tax shelters, and for the prevention of abuse in transactions more likely to benefit donors than the charity or the public.

- **Strengthen Enforcement.** Congress should increase IRS funding to enable it to enhance its oversight of charitable organizations. Congress should also amend laws as is necessary in order to enable the IRS and state charity officials to share information concerning charity oversight.

<sup>1</sup> Available at [www.nonprofitpanel.org](http://www.nonprofitpanel.org); authors Peregrine and Schwartz are members of the Legal Advisory Group of the Panel.

<sup>2</sup> This long-awaited proposal was expected to be released in series, with the first parts, which did not address governance issues, contained in the Senate-passed version of the Tax Reform Act of 2005. Whether those portions survive the House/Senate Conference Committee and are ultimately enacted into law is uncertain as of the publication date.

As of this date, the Senate Finance Committee has not introduced any of its long-promised legislative proposals addressing governance of exempt organization. To the extent such proposals do not find their way into law, the related recommendations of the Panel's Final Report may, over time, assume the level of *de facto* "best practices." Accordingly, they remain worthy of close attention by nonprofit organizations.

**2. The Rating Agencies Speak.** The value of adopting corporate accountability policies and procedures became much clearer with the midsummer 2005 release of separate reports from the three major rating agencies for the nonprofit health care industry: Moody's Investors Services, Fitch Ratings and Standard and Poor's. Each report commented to varying degrees on the relationship between corporate accountability and credit worthiness.

The Moody's "Special Comment," entitled "Governance of Not-for-Profit Healthcare Organizations," was released in June.<sup>3</sup> The key point of the Moody's Special Comment is that governance is, and will continue to be, an important dimension of credit quality in the nonprofit health care sector.

The factors Moody's considers in the course of its assessment of governance—as an "important component" of the credit profile of the institution—include the following: (a) development of organization's mission; (b) selection and evaluation of senior management; (c) board composition and performance; (d) understanding and interpretation of financial reporting; (e) use of performance metrics based on external benchmarks to regularly review the institution's performance; (f) maintaining and building the organization's financial resources; and (g) avoidance of conflicts of interest.

Fitch Ratings' Special Report, released on August 9,<sup>4</sup> concludes that Sarbanes-Oxley financial accountability and financial reporting requirements constitute "best practices" that should be "embraced" by nonprofit hospitals and health care systems. The Special Report outlines those provisions of Sarbanes-Oxley that Fitch Ratings identifies as most relevant for the credit rating process.

Of course, many not-for-profit hospitals and health systems have already taken steps to enact Sarbanes-Oxley principles. The significance of the Fitch Ratings Special Report is thus two-fold: First, it encourages adoption of the most controversial—to nonprofits—provisions of Sarbanes-Oxley: The Section 302 requirements regarding Certification of Financial Statements, and the Section 404 requirements concerning Internal Controls. Second, it identifies a series of questions that Fitch Ratings will ask the governing board and management team concerning the level of adoption of Sarbanes-Oxley by the institution, the answers to which will factor into Fitch Ratings' evaluation on the overall quality of corporate governance.

Fitch Ratings' emphasis on substantive Sarbanes-Oxley compliance is based in large part on its support for the basic principles of that legislation, and its belief that federal and state regulatory bodies will soon be enacting legislation that mirrors those basic Sarbanes-Oxley principles. What is particularly noteworthy, though, is the fact that Fitch Ratings (a) considers

<sup>3</sup> Available at [www.moody.com](http://www.moody.com).

<sup>4</sup> Available at [www.fitchratings.com](http://www.fitchratings.com).

Sarbanes-Oxley compliance to constitute “best practice,” AND (b) encourages nonprofit hospitals and health systems to abandon a “wait and see” attitude, and adopt those provisions of Sarbanes-Oxley which are not easy to implement, for example certification of financials and internal controls.

On Oct. 17, Standard & Poor’s issued a research report on regulatory and governance oversight of nonprofit corporations as an aspect of credit analysis.<sup>5</sup> The Standard & Poor’s report differs slightly from the Fitch Ratings and Moody’s reports in that it (a) more closely evaluates federal and state governmental efforts to regulate nonprofit oversights, (b) comments on the benefits of self-regulation, and (c) discusses corporate responsibility issues in the context of the nonprofit sector as a whole, without specific focus on the health care industry.

Governance factors cited as favorable from a credit analysis perspective include (a) the experience, leadership and philanthropic support provided by the nonprofit’s governing board, (b) the independence of the governing board, (c) the presence of clear planning and strategic goals, and (d) interestingly enough, the extent of regulatory oversight of the nonprofit.

Notably, the Standard & Poor’s report focuses on continuing legislative consideration of tax exempt status and its related benefits to the nonprofit organization, observing that the loss of such status, presumably at either the state or federal level, could have a “crippling effect” on a nonprofit. In this regard, the Standard & Poor’s report is distinguishable from the other two reports and provides an ominous reminder of the “stakes” of the related deliberations of the House Ways & Means Committee, and perhaps even of the property tax exemption challenges pending against several nonprofit hospitals and health systems.

Together, the three rating agency reports confirm the important role that governance oversight and corporate responsibility play in terms of the credit analysis of a nonprofit organization. Accordingly, it is prudent that these issues be closely considered by at least the finance committee, if not by the entire board of a nonprofit corporation.

**3. Continuing IRS Attention.** Charitable health care organizations were the subject of considerable IRS attention on a variety of fronts in 2005. Through the continuation of the IRS executive compensation initiative, new proposed Intermediate Sanctions regulations and an aggressive business plan for 2006, the IRS and the Treasury Department are essentially requiring health care boards to more closely oversee tax compliance issues.

**Executive Compensation.** In 2005, the IRS continued apace with its program announced in August 2004 of conducting correspondence-type audits of the executive compensation paid by approximately 2,000 exempt organizations. Although Internal Revenue Code Section 501(c)(3) organizations that reported combined aggregate compensation to any individual in excess of \$1 million have long been possible target(s) or these audits, several letters have gone to organizations with executive compensation of less than \$1 million. Some letters requested information on physician compensation in addition to, or instead of, executive compensation.

<sup>5</sup> Available at [www.standardandpoors.com](http://www.standardandpoors.com).

Organizations selected for this audit received IRS Letter 3878, which contains 11 standardized questions and several additional questions if facts and circumstances warrant. Some organizations selected for audit received a separate information document request (IDR), asking approximately 35 additional questions. The questions contained in each IDR are strikingly similar and are clearly drawn from a single master list.

The purpose of IRS Letter 3878, and attached IDR, is to provide the IRS with details on every type of economic benefit provided to disqualified persons and, to the extent not reported on the applicable Form 990, a reconciliation of such benefits to the amounts actually reported. Furthermore, the IRS is requesting detailed information on the exempt organization’s internal review processes, including the use of outside consultants and “hard copies” of any data supporting the reported compensation levels. The IRS also requires identification and discussion of any business or financial ties between the exempt organization’s disqualified persons and its independent contractors.

**Intermediate Sanctions.** The Department of the Treasury released proposed regulations on September 9 concerning Section 501(c)(3) and 501(c)(4) tax-exempt organizations that provide important guidance for avoiding revocation of tax-exempt status.<sup>6</sup> The “net effect” of the proposed regulations is that excess benefit transactions under the intermediate sanctions rules will not cause the loss of an organization’s tax exemption unless they are so extensive as to create questions about the organization’s overall purposes and operations. Moreover, organizations that have procedures in place to detect and prevent transactions benefiting insiders, and that act on their own initiative to discover and correct such transactions, are unlikely to have their tax exemption revoked by the IRS even if they engage in excess benefit transactions. This “common sense” approach to enforcement had long been predicted, and is particularly useful to the extent that it indicates specific steps exempt organizations can take to protect their tax-exempt status.

The proposed regulations also place a premium on effective tax compliance activity, potentially increasing the scope of responsibilities of the corporate compliance office. They highlight, perhaps more emphatically than in the past, the risk that in certain situations there may indeed be an extraordinarily severe organizational penalty associated with violation of the intermediate sanctions rules. In other words, they “raise the stakes” to the tax-exempt organization for engaging in and failing to discover and correct situations involving private inurement or private benefit.

**FY 2006 IRS Workplan.** Particularly significant was the late October release of information concerning the IRS “Implementing Guidelines” with respect to nonprofit, tax exempt organizations for the upcoming fiscal year.<sup>7</sup> This information reflects the materially increased level of attention that nonprofit, tax-exempt hospitals can expect from the IRS in 2005-2006.

It is clear from the Workplan that the IRS will continue to monitor executive compensation issues beyond the scope of its current “soft contact audit” initiative,

<sup>6</sup> Department of the Treasury, Internal Revenue Service, 26 CFR Parts 1 and 53, Reg. 111257-05.

<sup>7</sup> Available at [http://www.irs.gov/pub/irs-tege/fy\\_2006\\_implementing\\_guidelines.pdf](http://www.irs.gov/pub/irs-tege/fy_2006_implementing_guidelines.pdf).

which is to be completed in 2006. The IRS still intends to issue a report of its initial findings from the audits. Based upon those findings, the IRS expects to “target additional examinations and compliance checks.”<sup>8</sup>

**Other Initiatives.** Perhaps more noteworthy is the potential for an Exempt Organization Compliance Unit project aimed at determining how hospitals meet the community benefit standards for purposes of IRC Section 501(c)(3). This project would involve sending compliance check letters to a “significant number” of hospitals—at least 600—requesting that they answer certain questions regarding satisfaction of the community benefit standards, executive compensation and potentially other issues.

Also of note is the continued effort by the IRS to collaborate with the National Association of State Charity Officials, “to identify areas of mutual interest and explore ways to integrate our activities and strategies.”<sup>9</sup>

The Workplan also references the previously announced audit initiative addressing issues of private use and private benefit related to IRC Section 501(c)(3) bonds.

**4. The Grassley Letter.** The continued interest of the Senate Finance Committee in exercising oversight of the nonprofit health care sector was evidenced with a ten page letter from Committee Chair Sen. Charles F. Grassley to ten different, leading, nonprofit hospitals.<sup>10</sup> In his letter, publicly released on May 25, Senator Grassley requests that the recipient hospitals assist Congress in its review of tax-exempt organizations and submit responses to over 45 detailed questions, many of which involved detailed information for multiple years. Topics covered by these questions include (a) the provision of charity care and community benefit, (b) payments, charges and debt collection and (c) tax exemption, executive compensation and expenses, and other matters. Many of Senator Grassley’s questions relate to information that the responding health system may consider highly proprietary. Furthermore, these questions only add to the scrutiny tax-exempt hospitals face regarding general billing practices, property tax exemption challenges and class action lawsuits. Responses to the questions raised in the letters were due in early July.

In subsequent public comments, Sen. Grassley indicated that the Committee was unsatisfied by the initial responses to those letters and may issue follow-up letters seeking clarification. An additional round of letters, to other hospitals, may also be sent by the Committee.<sup>11</sup> Sen. Grassley’s interest continues to be with the lack of a common policy/common approach in the nonprofit, tax-exempt hospital industry concerning charity care and community benefit.

**5. American University.** The fall, 2005, controversy involving American University, its board of trustees and its former president/chief executive officer thrust into the spotlight a series of difficult oversight and compen-

sation issues that have broad implications for nonprofit organizations.<sup>12</sup>

The core issues raised by the American University situation include the appropriate levels of discretionary expenditures incurred by a chief executive officer of a nonprofit organization; the required degree of board oversight of the executive compensation process; and the appropriateness, manner of review and reasonableness of executive severance arrangements. The high profile nature of this controversy, coupled with the lack of clear regulatory guidance on many of the implicated legal issues, have combined to attract the broader attention of Congress, the IRS, and state charity officials.

The roots of the controversy were in an anonymous letter delivered to the board of trustees in the Spring of 2004, alleging various compensation and expense abuses by the CEO. After conducting an internal review, the University suspended the CEO and ultimately negotiated a severance arrangement with him. On October 27, the board’s acting chairman received an inquiry letter from Senator Charles F. Grassley, chair of the Senate Finance Committee, announcing the Committee’s intention to review the compensation-related decisions of the University and its board, and requested substantial additional documentation.<sup>13</sup>

The American University matter and the underlying allegations focused attention on a series of important nonprofit corporate governance and tax issues, including (i) board oversight of executive compensation; (ii) CEO employment contracting; (iii) board fiduciary duties; (iv) executive discretionary spending; (v) executive severance arrangements; and (vi) federal income tax reporting.

This controversy is consistent with the current, extraordinary level of Congressional, regulatory/IRS and general public focus on nonprofit executive compensation and board oversight of the process by which compensation is determined and monitored. It is, however, important to note that there has been no determination of any violations of law nor breach of fiduciary duty in connection with the matter.

**6. Ways & Means Committee Hearings.** Given the nonprofit board’s duties of oversight and obedience to charitable mission, the Spring, 2005 hearings of the House Ways & Means Committee regarding tax-exempt status for hospitals were particularly significant.<sup>14</sup>

The hearing on May 26 was called by Representative Bill Thomas for the specific purpose of examining hospital tax-exempt status. Particular issues covered at the hearings included (a) how the standards for hospital tax-exempt status have evolved over time, (b) what criteria are used to assess a hospital’s tax-exempt status and (c) if hospitals operate principally as businesses selling their services in a competitive market. This hearing was preceded by an initial hearing of the Committee, held on April 20, which focused on the general his-

<sup>12</sup> See series of related articles in September and October, 2005 appearing in *The Washington Post*, *The New York Times* and *The Chronicle of Philanthropy*. See also, Peregrine and Louthian, “American University: Significant Implications for Nonprofits”, *The Exempt Organization Tax Review*, December 2005 (p. 337).

<sup>13</sup> <http://finance.senate.gov/press/Gpress/2005/prg102805.pdf>.

<sup>14</sup> <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=415&comm.=0>.

<sup>8</sup> *Id.*, p. 14.

<sup>9</sup> *Id.*, pp. 12, 17.

<sup>10</sup> <http://finance.senate.gov/press/Gpress/2005/prg052505.pdf>.

<sup>11</sup> *Id.*

tory of the tax-exempt sector, the legal rationale for tax exemption and its economic impact.

In his opening remarks, Rep. Thomas said the tax-exempt status of the nation's nonprofit hospitals should be reviewed, and questioned the difference between nonprofit and for-profit hospitals. "Because hospitals are the largest single type of charitable organization," he said, "it makes sense to ask what the taxpayer is getting in return for the tens of billions of dollars per year in tax subsidies given to tax-exempt hospitals." IRS Commissioner Mark Everson agreed that it had become increasingly difficult to differentiate for-profit from nonprofit health care providers. However, Everson expressed concern that a bright-line test could have unintended consequences and said Congress should proceed with caution.

Testimony from researchers presented a varied picture. According to her research, Nancy M. Kane, Professor of Management, Department of Health Policy and Management, Harvard School of Public Health, said that many nonprofit hospitals do not provide charity care in amounts that would justify the value of their tax-exempt benefits. She urged Congress not to revoke the federal tax exemption for nonprofit hospitals but rather to strengthen the tax-exemption standard and tie it more specifically to the provision of charity care.

David M. Walker, Comptroller General, U.S. Government Accountability Office, presented a GAO study of five states that showed government hospitals, when compared to nonprofit hospitals, devoted substantially larger shares of their patient operating expenses to uncompensated care. Nonprofit hospitals in turn devoted more, but not as much more, of their operating expenses to uncompensated care as did for-profit hospitals.

On the other hand, Jill R. Horwitz, Assistant Professor, University of Michigan Law School, presented research indicating that for-profit hospitals, when compared to tax-exempt hospitals, were more likely to offer the most profitable services, less likely to offer unprofitable but essential services and more likely to initiate and drop services in response in changes in profitability. While no further hearings were held in 2005, the issue is expected to be revisited by the Committee in 2006.<sup>15</sup>

**7. The *Disney* Decision.** The Aug. 9, 2005, decision of the Delaware Chancery Court in the long-awaited, and highly publicized *Walt Disney Co.* shareholder derivative litigation offered important implications for the standard of conduct to be applied to health care corporate directors in the exercise of their oversight function.<sup>16</sup> The nature of the litigation related to the sufficiency of the Disney board's role in supervising certain major executive employment and compensation decisions which ultimately had unfavorable results for the corporation. In sum, the *Disney* ruling presented a strong affirmation of the traditional business judgment rule and of the importance of "process" and "good

faith" in decision-making. It did not, however, serve as a basis for relaxing levels of director attentiveness.

With respect to the conduct of each defendant-director/officer, the Court was highly critical. "For the future, many lessons of what not to do can be learned from the defendants' conduct here." Despite the articulated surfeit of failures, the Court concluded that no director acted in bad faith and each was, at most, ordinarily negligent, a finding which is insufficient to overcome the protection of the business judgment rule under Delaware law.

However, attorneys general and other state charity officials may be less willing to interpret *Disney*-type fiduciary lapses by nonprofit directors as protected under the business judgment rule, particularly where it is concluded that the level of inquiry conducted in advance of a decision did not constitute reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

In deference to the current "corporate responsibility" environment, the Court drew a significant distinction between "best practices" as an aspirational goal, and fiduciary duty, as a legal obligation. Nevertheless, the Court strongly encouraged directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken.

**8. The California Nonprofit Integrity Act.** This new legislation—arguably the most definitive statutory application of Sarbanes-Oxley principles to the nonprofit sector—became effective on Jan. 1, 2005.

This wide-ranging statute contains thirteen separate provisions, including requirements that (i) new charitable organizations have 30 days, rather than six months, to register and file articles of incorporation with the Attorney General; (ii) an independent audit of annual financial statements must be performed for charities with gross revenues of \$2 million or more, excluding certain governmental funding; (iii) charities with gross revenues of \$2 million or more must establish and maintain an audit committee made up of wholly financially independent members; and (iv) governing boards, or an authorized committee, must review and approve as "reasonable" the compensation of their chief executive officer/president and chief financial officer/treasurer. The Act also includes multiple provisions which regulate the role of commercial fundraisers and fundraising counsel to charitable organizations.<sup>17</sup>

Of particular interest on a national perspective are those provisions of the Act relating to the constitution of the audit committee, and the executive compensation oversight practice.

The audit committee cannot include in its membership individuals who are organizational staff members, the president/chief executive officer, treasurer or chief financial officer. While members of the organization's finance committee may serve on the audit committee, they may not comprise 50% or more of its membership.

With respect to executive compensation, it is important to note that the required board/committee review relates not only to the president/chief executive officer, but also to the treasurer/chief financial officer. Further-

<sup>15</sup> Note that the Ways and Means Committee recently requested that GAO conduct a survey of nonprofit hospital systems on their executive compensation practices. Survey results were due January 24, 2006.

<sup>16</sup> *In re Walt Disney Co. Derivative Litigation*, No. 15452 (Del. Ch. Aug. 9, 2005).

<sup>17</sup> Cal. Govt. Code §§ 2580-12599.7; see also [http://ag.ca.gov/charities/publications/nonprofit\\_integrity\\_act\\_nov04.pdf](http://ag.ca.gov/charities/publications/nonprofit_integrity_act_nov04.pdf).

more, the compensation review is to be conducted (a) at the time the officer is hired; (b) when the term is extended; and (c) when the compensation is modified.

Finally, there is some question as to the extent to which the Act's provisions, including but not limited to the provisions regarding audit committee and executive compensation, apply to foreign charities that conduct business in California.

**9. The Nature Conservancy.** The two year corporate accountability tribulations of The Nature Conservancy ("TNC"), which had broad implications for the non-profit sector in general, concluded in midsummer 2005 with a final presentation to the Senate Finance Committee and the end of a related audit.<sup>18</sup>

In its Senate presentation, The Nature Conservancy presented a summary of the various governance changes and reforms that it had instituted over the prior 22 months, a period that began after reports in *The Washington Post* first brought public focus on certain aspects of its business practices and corporate governance structure. Three features of these changes and reforms offer particular lessons and guidance to non-profit hospitals and health systems considering their own governance practices:

- *Governance Roles and Responsibilities.* Responding to concerns that its governing board was too large and ineffective, TNC reduced the board's size from 41 to 21 members, reduced the number of committees from six to three and increased the number of required in-person board meetings from four to three times per year. Board members were also restricted to service on only one board committee, to increase the effectiveness of their oversight.

- *Sarbanes-Oxley Reforms.* TNC's board also adopted policies and procedures reflective of many of the core principles of Sarbanes-Oxley. These included enhanced audit committee practices, a broader role for internal audit staff, appointment of a chief compliance officer and an internal "whistleblower" mechanism, board approval of executive compensation, improved transparency of the Form 990 filing and a prohibition on loans to executive officers.

- *Conflicts of Interest.* The TNC conflicts of interest policy was revised to enhance its coverage and application "beyond legal requirements". Principal among the changes was an expanded definition of who is considered a related party, new training policies and an expanded process for reviewing potential conflicts of interest.

The significance of the TNC action is that it offered specific examples of how a sophisticated charitable organization may prudently respond to the pressures of the current corporate responsibility environment.

**10. Travel and Entertainment Expenses.** This seemingly minor, but sensitive, issue received substantial and broad based regulatory and legislative attention in 2005. Specifically, there occurred during the year a material level of focus on the officer and director travel and entertainment policies and procedures of nonprofit organizations. This topic was raised with interest in forums by a disparate as state attorney generals, in the context of business compliance reviews; the IRS, par-

ticularly with respect to personal use of corporate cell phones; and in Congressional testimony.

For example, Minnesota Attorney General Mike Hatch devoted an entire 31 page section of his January 31, 2005 business compliance review report of Fairview Health System to the travel and entertainment issue.<sup>19</sup> Consistent with prior practice, his review focused on expenditures related to travel and entertainment by board members and executives, travel by executives, holiday parties and reimbursement for other parties, expenditures associated with retreats and other off-site activities, gifts, executive memberships and sports entertainment/golf. His report did, however, commend Fairview for changing its policies in this regard.

The issue was also addressed in testimony before the Senate Finance Committee at its April 5, 2005 hearings on compensation in the nonprofit sector, as part of the questions presented in many of the IRS "soft contact" audits of exempt organizations in 2005, and in the May 25 letter issued by the Finance Committee to ten large nonprofit hospitals and health systems. In addition, the Final Report of the Panel on the Nonprofit Sector recommended a ban on nonprofit organizations reimbursing expenses associated with travel and entertainment for the spouses of corporate officers and directors.<sup>20</sup> This level of focus is expected to continue into 2006, and may also be addressed in federal legislation introduced by the Finance Committee.

**Honorable Mention.** Other 2005 nonprofit corporate developments worthy of note include the following.

The Senate Finance Committee's December 29 governance inquiry letter to the American Red Cross;<sup>21</sup> the December 22 agreement to appoint a federal monitor over the governance and operations of University of Medicine and Dentistry of New Jersey;<sup>22</sup> the January, 2005 business compliance review of Fairview Health System by Minnesota Attorney General Mike Hatch;<sup>23</sup> the August, 2005 ruling by the Minnesota court in favor of Medica Health Plans in its long-running governance dispute with Attorney General Hatch;<sup>24</sup> the role of the Texas Attorney General in resolving the frayed corporate affiliation between Baylor and Methodist hospitals and health systems in Houston;<sup>25</sup> developments in the ability of third parties to assert standing against nonprofit organizations, for example decisions in the L. B. Research Foundation and Hershey cases;<sup>26</sup> the implications to nonprofit directors/trustees arising from the settlements in the WorldCom and Enron shareholder derivative litigation in January; and the December, 2005 decision by the Mississippi Supreme Court in a charitable trust controversy involving a nonprofit hospital.<sup>27</sup>

<sup>19</sup> Available at <http://state.mn.us/consumer/consumerprotection/050131/fairviewhealthservices.htm>.

<sup>20</sup> See Panel Report, *supra* fn. 1, at p. 73.

<sup>21</sup> Available at <http://finance.senate.gov/press/Gpress/2005/prg122905.pdf>.

<sup>22</sup> BNA Health Care Daily Report, Vol. 10, Number 247, December 28, 2005.

<sup>23</sup> See fn. 18, *supra*.

<sup>24</sup> *Minnesota v. Medica Health Plans*, Minn. Dist. Ct., No. MC 01-00410, 8/17/05.

<sup>25</sup> See <http://www.chron.com>, Aug. 31, 2005.

<sup>26</sup> 130 Cal. App. 4th 171 (2005); 867 A.2d 647 (2005); see also, 2005 Pa. Lexis 2695 (Pa., Dec. 1, 2005).

<sup>27</sup> *City of Picayune v. Southern Regional Corporation*, Miss., No. 2003-CA-DU219-SCT, 12/18/05.

<sup>18</sup> See <http://finance.senate.gov/press/Gpress/2005/prg060705.pdf>; see also <http://nature.org>.

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**Conclusion.** 2005 was a year in which developments in nonprofit corporate law, as applied to hospitals and health systems, continued apace. Of particular significance was the increased level of regulatory interest in governance practices of nonprofit organizations, and a willingness to closely review and question such practices.

Collectively, these developments reflect greater interest in the application of nonprofit and charitable trust

law concepts on a variety of public and private levels. It is the authors' perspective, however, that these developments should not be a basis to question the continued propriety and reasonableness of nonprofit status. Rather, counsel to such organizations should be mindful of identifying nonprofit corporate law as a principal legal issue when conducting any material legal analysis for a health care client.