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Nonprofit Corporate Governance

Key Nonprofit Corporate Law Developments in 2004

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The year 2004 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 legal feasibility consideration for the nonprofit hospital/health system.

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/Sarbanes/Oxley-based compliance; (c) Fiduciary standards of conduct; (d) Corporate financial performance and disclosure; and (e) Business transactions, both external and intra-system.

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Furthermore, these developments reflect the continuation of corporate law trends that the authors believe counsel should consider as they advise their nonprofit health care clients on transactional, structural and governance matters. These trends include:

- (a) The continued "close scrutiny" by state attorneys general of the business practices of nonprofit health care providers;
- (b) The ongoing pattern of stakeholders using charitable trust laws to obtain remedies that would not be available under nonprofit corporation law;
- (c) The willingness of legislators, courts and regulators to hold nonprofit directors accountable for the conduct and performance of the corporations they serve;
- (d) The expanding influence of third party interest groups with respect to oversight of nonprofit law compliance; and
- (e) A recognition that the public policy principles behind Sarbanes-Oxley-related reforms apply in large part to nonprofit corporations.

Based upon these trends, our "top ten" list of major nonprofit developments for health care providers in 2004 follow.

1. Continued Focus on Director Conduct. A combination of cases, controversies, enforcement actions and "best practices" developments in 2004 cast significant focus on the conduct of corporate directors. For example, the Boston University controversy in January spoke to the propriety of directors simultaneously serving as vendors to the corporation, and to the value of

being able to demonstrate majority board control in “independent” directors. Delaware court decisions involving Oracle Corp.¹ and Martha Stewart Living Omnimedia,² suggested that director bias could arise from material non-financial relationships, as well as from financial relationships. Despite introduction of its new Form 1023, with heavy focus on the adoption of a conflicts of interest policy, the IRS’ template conflicts policy was subject to criticism for the narrowness of its scope, given expanded corporate and judicial attention to director conflict and bias (13 HLR 1552, 10/28/04). The November adoption of the Amended Federal Sentencing Guidelines was significant in its assignment of additional compliance plan oversight obligations to corporate directors. Prominent controversies involving Fannie Mae and Hollinger International involved, in part, issues related to alleged lax governance oversight of financial matters, particularly at the audit committee level. The Jan. 23, 2004, decision of the Delaware Chancery Court in the *E-Bay*³ derivative litigation provided an easy-to-understand example of director appropriation of corporate opportunity. Emerging best practices related to such important concepts as director “fitness”; the increased use of executive sessions; the role of the “chief governance officer” (particularly in larger organizations); the appointment of a “Lead Director” when the Board Chair is also an interested director; and the proper role of the corporate secretary, particularly with respect to minute-taking. Litigation involving *Boston Regional Medical Center, Inc.*⁴ focused on the fiduciary duties of a governing board while the corporation is within the “zone of insolvency.”

2. Continued State Oversight. 2004 also witnessed a continued high level of state involvement in business transactions of nonprofit corporations. Charitable trust-related controversies were highlighted by a March, 2004 settlement involving Banner Health’s sale of several of its South Dakota facilities, and the related internal allocation of net proceeds from sale (13 HLR 413, 3/25/04). In addition, the attorneys general of Texas and several other states applied charitable trust theories to challenge the professional advisor expenses of the nonprofit National Benevolent Association. A state court decision in August confirmed the authority of the Minnesota Attorney General to exercise oversight of the continued ‘corporate rehabilitation’ of the health care plan, Medica.⁵ This litigation was a continuation of the original business compliance review of Allina Health System. The collapse of PipeVine, Inc., a Bay Area charity that processed contributions for The United Way, and subsequent California Attorney General investigation, focused attention on the board’s oversight of financial matters in general and of corporate financial feasibility in particular. New York Attorney General Spitzer’s action seeking rescission of the compensation payable to NYSE CEO Richard Grasso is based upon appropriate board compensation practices of nonprofit

corporations (like the NYSE).⁶ General Spitzer’s complaint applies the same principles of nonprofit corporate law that other attorney generals could be expected to use to challenge executive compensation practices of other nonprofit corporations. Alleged lapses in financial oversight (as well as criminal concerns) were also at the core of General Spitzer’s review of the financial practices of the James Beard Foundation, a culinary-focused nonprofit.⁷ The Department of Interior reviewed the governance oversight practices of the Statue of Liberty Foundation. The New Hampshire Attorney General achieved a settlement with respect to the “executive” compensation practices of the prestigious St. Paul’s School.

In June, 2004 testimony before the Senate Finance Committee, the National Association of Attorneys General identified their leading charity-oversight regulatory priorities as (i) increasing the accuracy and timeliness of report; (ii) information sharing among regulators; and (iii) exploiting technology in electronic filing⁸.

3. State “Corporate Responsibility” Statutes. After a significant incubation period, state corporate responsibility legislation began to emerge in 2004. New York Attorney General Spitzer’s legislative proposal, the initial “entry in the field,” remained without sponsorship in 2004. The Massachusetts Attorney General gave close consideration to the development of such legislation, including the use of an advisory group. However, the enactment of the California Nonprofit Integrity Act of 2004 (effective January 1, 2005) was the most prominent development, it being the first true state “Sarbanes for Nonprofit” legislation to be enacted.⁹ The California statute contains three main components: (a) a requirement for the formation of a discrete audit committee of the board; (b) board/committee review of executive compensation arrangements; and (c) enhanced regulation of charitable solicitation activities. It also establishes certain requirements with respect to preparation of audited financial statements. The California statute also has a “long arm” component, with some of its provisions applicable to foreign corporations deemed to “conduct business” in California. Similar legislative proposals in other states also address such additional issues as (a) executive certification of financial statements; (b) related party transactions; (c) whistleblower protection; and remedies for violations.

4. Congressional Initiatives. One of the most significant developments in 2004 – and one with the greatest potential for long-term impact – was the Senate Finance Committee’s pursuit of federal oversight litigation over nonprofits. The Committee’s actions were fueled in large part by Committee Chair Sen. Charles Grassley’s long-time interest in charity regulation, including Committee hearings held concerning controversies at prominent charities such as The United Way of the National Capital Area, and The Nature Conservancy. The Committee held highly-publicized hearings on charity

¹ *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 2 EXC 16 (Del. Ch. 2003).

² *Beam v. Stewart*, Del., No. 501, 2003, 3/31/04).

³ *In re eBay Inc. Shareholders Litig.*, Consolidated C.A. No. 19988-NC, 2 EXC 14 (Del. Ch. Jan. 23, 2004) (unpublished).

⁴ *In re Boston Regional Medical Center Inc.*, D. Mass., No. 01-10572, 8/4/04; 13 HLR 1221, 8/19/04.

⁵ *Hatch v. Allina Health System*, Minn. Dist. Ct., No. MC 01-004160, 8/14/03; 12 HLR 1303, 8/21/03).

⁶ *People v. Grasso*, N.Y. Sup. Ct., No. 401620/04, 5/24/04; 13 HLR 770.

⁷ See, e.g., Julia Moskin, “Beard Foundation Audit Shows Malfeasance”, *The New York Times*, Dec. 16, 2004.

⁸ Testimony from the hearing is available at the committee website at <http://finance.senate.gov/index.html>.

⁹ Nonprofit Integrity Act of 2004, CA Senate Bill 1262, signed by Gov. Arnold Schwarzenegger (R), Sept. 29, 2004.

oversight on June 22. Subsequent to the hearings staff to the Committee issued a “draft” legislative proposal for federal charity oversight, which was broad in scope (13 HLR 950, 6/24/04).¹⁰

Key components of the draft staff proposal included the following:

- *Proposed New IRS Review and Enforcement Powers*, including a review of exempt organization tax status every five years, reform of type III supporting organizations (a classification shared by many health care parent organizations), revocation of exempt status for accommodating improper tax shelters, penalties for inaccurate or nontimely disclosure; and federal standards for conversion to for-profit status. The proposal would also implement materially enhanced Form 990 reporting requirements reflecting interest in additional governance “best practices,” e.g., independent audit committee, corporate structure information, CEO/CFO verification, and enhanced public document disclosure (as to investments, financial statements and performance goals), among other matters.

- *Federal Governance Oversight*. The draft proposal would also have the effect of “federalizing” nonprofit corporate law, through a variety of controversial provisions: institution restrictions on the size and membership of the board of directors, making breach of fiduciary duty a violation of federal law, and giving the federal Tax Court board equitable powers, including the ability to effect the removal of directors and officers of a nonprofit corporation. The draft proposal would also add new, federal-based derivative action powers, i.e., authorizing standing to individual directors and officers to institute action in the name of the charity.

The Independent Sector has convened a “Panel on the Nonprofit Sector” to respond to the Senate Finance Committee’s call for recommendations relating to nonprofit governance oversight matters that the Committee is considering.

5. More on Sarbanes. The implications of Sarbanes/Oxley and its supplemental rulemaking continued to impact nonprofit corporations in 2004, two years after the date of enactment of the seminal legislation. While many health care organizations had by 2004 adopted in material part the most clearly relevant portions of the statute, the effects of the statute were being felt in different areas. A growing number of state bar associations adopted revisions to their code of professional ethics to acknowledge the policy implications of Sarbanes Section 307. Many health care organizations also worked to satisfy internal control issues arising from Section 404. Auditor independence issues, and the ability of audit committees to effectively “pre-clear” the provision of certain non-audit services by the independent auditor, remained important areas of corporate concern. Document retention policies were revised and “upgraded” to satisfy “obstruction of justice” provisions of Section 802. Final rules were issued in connection with “whistleblower protection” and audit committee organization and operations. Finally, with the second anniversary of the enactment of the statute came a vigorous public debate about the cost and effectiveness of the statute, with the consensus leaning towards an

acknowledgment of its fundamental commercial and policy benefits.

6. Increased Role of Third Parties. In 2004, third parties—apart from the traditional regulatory agencies—assumed an aggressive new role in monitoring the organization and operation of nonprofit charities. Prominent among these is the Better Business Bureau/Wise Giving Alliance, a monitoring organization that sets voluntary accountability standards for charities.¹¹ These standards were developed to assist donors in making sound giving decisions, and to promote increased public confidence in the charitable sector. The accountability standards relate to such fundamental matters as governance, expenditures, truthfulness of representations and financial transparency/disclosure. Significantly, in 2004 BBB/WGA also introduced an “Online Charity Reporting and Evaluating System,” permitting it to automatically evaluate charity data and “dramatically expand” the extent of its national charity reports. The success of the plaintiffs in the Princeton University litigation avoiding a motion to dismiss reflected an increasing judicial willingness to allow donors to independently assert standing in actions against nonprofit donee organizations. Notably, uninsured patients are serving as the plaintiffs in the prominent litigation challenging the charity care practices of many of the leading nonprofit hospitals and health systems. Former patients are also serving as the plaintiffs in similar litigation challenging hospital local property tax exempt status. Labor unions, consumer groups and other similar third party public interest groups have also played an increasingly active role in 2004 in supporting state action against nonprofit organization activity. For example, the American Federation of State, County and Municipal Employees has been aggressive in its public challenges against hospital charity care practices and their federal and state tax exempt status. This is consistent with actions of such groups as the Service Employees International Union, as well as the National Women’s Law Center, in challenging certain practices of Catholic-sponsored health care systems. Consumers Union has also been aggressive in its support of state oversight of nonprofit health care, including with respect to charitable trust issues and intra-system asset transfers.

7. Focus on Executive Compensation. One of the most significant IRS enforcement initiatives in the nonprofit sector in recent years was launched in 2004, with focus on the executive compensation practices of nonprofit, tax exempt organizations (13 HLR 1183, 8/12/04). The initiative was commenced against the backdrop of an IRS admission of its “slow initial response” to what it described as the growing problem of abuses involving charities. This initiative arose in the midst of an expressed Congressional concern that the IRS was not receiving sufficient funding to pursue enforcement activity. IRS Commissioner Everson spoke to directly to these concerns in testimony before the Senate Finance Committee’s Hearings on the Nonprofit Sector in June. The executive compensation review had initially been intended as a “soft contact” review of approximately 200 leading charitable organizations. However, on August 10 the IRS announced the conversion of the review

¹⁰ Text of the discussion draft of the committee staff’s proposals for reforms is available at <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>.

¹¹ <http://www.give.org/>.

into a specific Tax Exempt Enforcement Project, consisting of examinations and other contracts. As part of this revamped review, the IRS expanded the number of targeted organizations from 200 to 2,000 charities and foundations. The IRS announced that its inquiries, it would be seeking information regarding the executive compensation practices of these organizations (both the reasonableness of specific arrangements, and the process by which reasonableness is determined, with particular focus on the board's compensation committee). In related matters on a state level, the Texas Attorney General successfully challenged the executive compensation practices of the King Foundation in a jury trial that returned punitive damages. The Rhode Island Attorney General reviewed the executive compensation arrangements payable to the retiring CEO of Blue Cross & Blue Shield of Rhode Island (13 HLR 713, 5/13/04). These cases are consistent with the "waste of assets" cases mentioned above which relate to executive compensation arrangements (see, above, e.g., *Spitzer v. Grasso* (New York); *St. Paul School* (New Hampshire)).

8. Major Controversies/Regulatory Intervention. The media played an important role in "sparking" or enhancing other regulatory oversight activities with respect to nonprofit organizations in 2004. For example, the Nature Conservancy's ("TNC") governance and business practices were the subject of continued Senate Finance Committee review in 2004 and its travails may have served as a catalyst for the Senate Finance Committee Hearings on Nonprofits. Yet, much of the related controversy can be traced to a multi-part expose of TNC operations which first appeared in *The Washington Post* in 2003. On March 19, 2004, TNC released its well-received Report of the Governance Advisory Panel to the Executive Committee and to the Board of Governors.¹² This Report set forth a series of in-depth recommendations on improving governance oversight and financial transparency. Similarly, close coverage by *The Boston Globe* brought to light certain governance challenges at Boston University, which were ultimately considered by the Massachusetts Attorney General. At issue were concerns with respect to possible "waste of corporate assets" and a governing board allegedly controlled by directors simultaneously serving as vendors to the university. These concerns were ultimately resolved with the April 15 Report of the University Board's Ad Hoc Committee on Governance.¹³ Precise and attentive coverage of the charitable community by *The New York Times* focused public attention on the governance controversies at a number of leading charities, including the James Beard Foundation (ultimately investigated by the New York Attorney General) and the Statue of Liberty Foundation (ultimately investigated by the Department of Interior and the Senate Finance Community). For example, the Statue of Liberty controversy was based upon concerns that it was pursuing a major capital campaign while it held a \$30 million endowment. A special investigative committee reviewed specific issues relating to executive compensation, financial accounting, endowment control investment, and mission, role and effectiveness. The

¹² Text of the report is available at http://nature.org/pressroom/files/gap_final.pdf.

¹³ Text of this report is available at <http://www.bufuture.net/tr-report.pdf>.

Chronicle of Philanthropy published a detailed report reviewing loans made by charitable organizations to their executives, which report may have been influential to the Senate Finance Committee and the Internal Revenue Service in their attention to exempt organization executive compensation practices.¹⁴

9. Emergence of Best Practices. A particularly significant development for nonprofit corporations in 2004 was the continued development of corporate governance "best practices." These "best practices" have emerged from a variety of different sources: public policy groups (e.g., National Association of Corporate Directors, The Business Roundtable, The Conference Board); self-regulatory agencies (e.g., New York Stock Exchange, NASDAQ); consumer groups (e.g., the Independent Sector, the BBB/Wise Giving Alliance); professional associations (e.g., the American Bar Association, National Association of College and University Business Offices); and major corporations (e.g., Boeing, General Electric, MCI/WorldCom).¹⁵ The basic focus of the various "best practices" compilations is the development of aspirational goals reflecting the multiple governance-related lessons of the corporate responsibility environment. The impact of "best practices" is not certain; they do not constitute legal standards or refinements of the law. However, given their purpose and evolution, they may be used as standards "of default" by courts and state charity regulators seeking appropriate standards of care to apply to particular nonprofit director conduct.

Areas most often addressed in "best practices" compilations included the following: consistency of actions with mission; relationship between the board and the "senior leadership team"; the board's oversight obligations; duty of loyalty compliance; financial accountability and transparency; the organization and functions of key board committees (e.g., governance/nominating; audit; executive compensation; corporate ethics/compliance); the relationship between the board, the senior leadership team and the general counsel; board deliberative processes; fund-raising accountability and "disqualified person" transaction review.

Events in 2004 also continued to suggest a potential relationship between an organization's adoption of "best practices," and evaluation of creditworthiness by the bond rating agencies.

10. Evolving Role of General Counsel. Another 2004 development with potential long-lasting implications has been the subtle evolution and expansion of the role of the nonprofit general counsel, emerging from the corporate responsibility environment. This new role reflects specific new requirements set forth in Sarbanes and its rulemaking, provisions of "best practices" compilations, and a recognition that many new legal-based governance and organizational tasks have begun to emerge and require attention.

For example, the provisions of Section 307 of Sarbanes and related changes in state bar ethical rules requires the corporate general counsel to be more attentive to "reporting up" and "reporting up" ethical obligations. Similarly, the general counsel is best made

¹⁴ Lipman and Williams, "Assets on Loan", *The Chronicle of Philanthropy*, Feb. 5, 2004.

¹⁵ See, e.g., <http://www.independentsector.org/>, <http://www.brtable.org/>.

responsible for compliance with the document retention/obstruction of justice provisions of Sarbanes Section 802.

In addition, litigation concerns have increased the role of the corporate counsel in the no-longer-ministerial tasks of agenda, minutes and resolution preparation. The corporate counsel is also now called upon to monitor rulemaking under Sarbanes Oxley and state governance statutes for relevant implications. Other new roles for the general counsel include preparation of governance policies, providing advice to key governing board committees, and monitoring external corporate and board disclosure. Finally, the increased importance of conflicts resolution calls for the general counsel to be materially more involved in all aspects of the organization's conflicts of interest identification and resolution process. All of these additional new duties have prompted larger nonprofit health systems to consider asking their general counsel to assume the addi-

tional role of "Chief Governance Officer," an increasingly common position in Fortune 500 firms.

Conclusion. 2004 was a year in which developments in nonprofit corporate law with application to health care providers continued apace. Of particular significance was the focus on director liability in the post-Sarbanes climate, and the emergence of federal oversight initiatives.

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 reason to question the continued propriety and reasonableness of nonprofit status. Rather, counsel to such corporations should be mindful of identifying nonprofit corporation law issues as a principal legal issue when conducting any material legal analysis for a health care client.