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Nonprofit Corporations

New Duties for the Nonprofit General Counsel In the Corporate Responsibility Environment

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Any post-Sarbanes-Oxley governance review by a nonprofit corporation should logically consider an expanded role for the corporate general counsel.

The corporate responsibility environment prompted by the seminal Sarbanes-Oxley Act of 2002 has had a dramatic spillover effect on the conduct of nonprofit governance. New rules, regulations and standards of conduct place increased obligations and oversight demands on both the nonprofit corporation, and its governing board. The corporate general counsel is uniquely well qualified to assist the corporation and its board in responding to such obligations and demands. To better protect the liability profile of both the nonprofit corporation and its board, the general counsel should be assigned the duty of providing advice on the broad topic of "corporate responsibility compliance."

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What tasks are encompassed within such an amorphous description? The "body of evidence" emerging since the enactment of Sarbanes-Oxley suggests expanding the role of the general counsel to include tasks falling within the following five areas:

- Helping direct the corporation's efforts to comply with emerging legislative, regulatory and judicial developments affecting corporate responsibility and governance.
- Serving as "staff" to important board committees faced with enhanced corporate responsibility-related duties, e.g., audit, executive compensation, governance/nominating, compliance.
- Assuming (or supporting) the traditional role of the corporate secretary as it relates to preparation of board agendas, minutes, resolutions and related information submitted to the board, and the maintenance of corporate records.
- More directly advising the board on the selection of key independent advisors whose work has corporate responsibility-related implications, e.g., auditors, compensation consultants, executive search firms, valuation advisors and, where circumstances warrant, independent counsel.

■ Participating more directly in director training, education and evaluation.¹

The adoption of these recommendations would materially enhance the prominence of the general counsel within the internal management hierarchy—placing the general counsel, in essence, in the role of chief governance officer of the corporation. This is a position which is being established with increased frequency by major American corporations in an attempt to effect compliance with dramatically increased corporate responsibility obligations.² These recommendations are also intended to be consistent with the important “best practices” proposals on the role of the general counsel adopted in 2003 by the American Bar Association in its much-discussed “Cheek Report” on corporate responsibility.³ The Cheek proposals spoke to the important compliance benefits of a properly functioning office of general counsel, and to the value of a general counsel more directly involved in advising the board of directors (including, particularly, its independent members) on the legal risks confronting the corporation.

Perhaps most importantly, these recommendations reflect a perspective that not only must the nonprofit corporation confront these new corporate responsibility challenges, but also that these challenges are fundamentally legal in nature, and thus that the general counsel (and not, for example, a consultant, auditor or strategic planner) is best qualified to advise the nonprofit corporation with respect to them. These enhanced roles for the general counsel will require a heightened sensitivity on the part of nonprofit boards and executives to the value that a knowledgeable and experienced general counsel can bring to many aspects of the corporation’s governance that are outside traditional norms. Further, they may likely require an expansion of the personnel and financial resources available to the office of the general counsel. Nonetheless, in the rapidly evolving dynamics of corporate governance and accountability, the unique perspective of the general counsel can add value, and enlightened nonprofit boards will come to recognize this.

A closer examination of each of these recommended areas of increased responsibility follows.

Corporate Governance Compliance

The general counsel should assume an enhanced role in advising the corporation and its governing board on compliance with emerging statutes, regulations and common law developments addressing corporate responsibility, governance and Sarbanes-Oxley-related matters. Examples of such developments would include compliance with those provisions of Sarbanes-Oxley

which are arguably applicable to nonpublic and non-profit corporations, e.g., prohibitions against document destruction and whistleblower retaliation. Similarly, the general counsel would advise the corporation with respect to specific state corporate responsibility statutes, such as the recently enacted California Senate Bill 1262⁴ and other similar provisions which place new obligations on how the nonprofit governing board effects financial oversight.

Another important area of attention would be advice in connection with recent judicial decisions interpreting the expected standard of conduct of corporate directors and officers and their related liability profile. This is especially important with those cases that address the distinction between negligence, gross negligence and “bad faith.” The actions (and deliberative processes) of corporate boards, both for-profit and nonprofit, are subject to more scrutiny and “second-guessing” than ever before, and the general counsel should be charged with keeping directors and officers abreast of new developments in this area.

The general counsel would also be a logical source of information to the board and senior leadership team on the application of other provisions of Sarbanes-Oxley that may be indirectly relevant on public policy grounds, and on other emerging standards of corporate governance “best practices.” While more often in the form of aspirational goals than legal requirements, it is important that the board be given the opportunity to consider the prudence of “best practices” application, in whole or in part, to the particular nonprofit. Directly related to this task would be the responsibility to draft, and subsequently advise on conformity with, governance policies and procedures relating to board performance and conduct.

It is also appropriate that the board look to its general counsel (and not, for example, to a non-lawyer compliance officer or outside compliance consultant) on the important oversight obligations emerging from amendments to the U.S. Sentencing Guidelines and from compliance plan guidance issued by the Office of Inspector General, Department of Health and Human Services. The general counsel could reasonably be expected to play a leading role in communicating the nonprofit’s corporate responsibility compliance with its external constituents (e.g., the community at large, patients, donors, bondholders). This would be manifested most directly in such matters as bond disclosures, press releases, Form 990 reporting, charitable solicitations and annual reports, and in the maintenance of a “governance” page on the corporate website.

Corporate Secretary Function

In the emerging environment, the general counsel should likely take on much greater involvement in the duties, activities and work product of the corporate secretary—if not actually assuming that position.

One of the most dramatic spillover effects of the post-Sarbanes environment has been an intense scrutiny on the deliberative process of the governing board as it relates both to the exercise of the board’s general oversight obligations, and to its duty of care with respect to particular decisions. Especially with respect to controversial decisions and to dramatic reversals of corporate

¹ See, e.g., “General Counsel’s Role Being Reshaped In Wake of Corporate Governance Reforms,” *BNA’s Corporate Accountability Report* (henceforth, “CARE”), Vol. 2, No. 24, p. 612 (June 11, 2004); “Books and Records Inspections Present New Issues for Companies,” *CARE*, Vol. 2, No. 23 (June 4, 2004); “Attorneys Dig Deeper into Merits of Memorializing Board Practices,” *CARE*, Vol. 2, No. 8 (Feb. 20, 2004).

² Tamara Loomis, “Companies are Hiring Chief Governance Officers”; *National Law Journal*, Vol. 25, No. 33, p. A15 (May 5, 2003); Donna Howell, “Firms’ Newest Security Measures: Their Chief Governance Officers at Hot Job These Days”; *Investor’s Business Daily*, Sept. 12, 2003.

³ Am. Bar Ass’n Task Force on Corporate Responsibility, *Report of the American Bar Association Task Force on Corporate Responsibility*, 59 *BUS. LAW.* 145 (Nov. 2003) (hereinafter *Cheek Report*), 2004 Cal.

⁴ Stat. Ch. 919 (signed into law Sept. 29, 2004).

financial fortune, there is often laser-like focus on such fundamental matters as (a) what information was provided to the board on a particular matter? (b) what was the extent of board deliberation on the matter? (c) was the board granted access to participating members of the senior management team and to professional advisors (and correlatively, did senior management dominate or unduly influence the board's deliberations)? (d) were the advantages and disadvantages of, and alternatives to, a particular decision, thoughtfully addressed? and (e) did any directors dissent from the vote?

All of this places a premium on the role of board agendas, minutes, resolutions and other traditional vehicles by which board action is documented. In an environment where so many parties and interest groups are ready to criticize exercise of a board's fiduciary duties, these vehicles may—where properly and accurately prepared—serve as a formidable defense to any challenge to board action. Where improperly, inaccurately or superficially prepared, they can pose a material evidentiary threat to the board and the corporation.

Given these stakes, it becomes important for the board to take advantage of the related legal training and sensitivity of the general counsel. This is by no means intended to denigrate the dedication, value and contributions of the traditional and well-trained corporate secretary who nevertheless lacks legal training. Rather, it is a recognition that the importance of that position—and the qualifications for its effective exercise—have dramatically changed in the post-Sarbanes environment.

Perhaps nowhere is this changed perspective more evident than in the once ministerial role of minute taking, which is now evolving to “art form” status. While no clear “best practice” has yet to emerge, general counsel and astute board members are clearly re-evaluating the wisdom of the once popular “minimalist” approach to minute taking. A key focus on the sufficiency of minutes is whether they adequately describe the depth to which a board evaluated a material issue, and the presence of dissenting director views/votes. In the current environment, the corporate secretary must balance the need for accurate reporting with the risk of having the minutes create a “roadmap” for potential litigation or other unwanted scrutiny. While many enlightened practitioners would still probably recommend limited detail in board minutes, clearly the expected scope of what will be covered is expanding, and the risks posed by excessive rounds of revision are likewise expanding.

The direct role of the general counsel in the minute-taking process could be to provide “real time” advice concerning the appropriateness of subsequent reviews and editing of draft minutes by other participants in the meeting. While the interests of accuracy should demand some review and editing of the initial draft, the potential exists that “too much editing” could create negative inferences about the purpose and legitimacy of the editing.⁵ General counsel involvement in the minute-taking process can also be helpful to ensure appropriate treatment for any portion of a meeting in which legal counsel made a presentation to the board

⁵ Susan Pulliam, Susanne Craig, Aarm Lucchetti and Randall Smith, “Persistent Pitfalls: How Hazards for Investors Get Tolerated Year of the Year,” *The Wall Street Journal*, Feb. 6, 2004.

that was intended to be subject to the attorney-client privilege.

The general counsel may also provide guidance to the independent directors on the appropriateness and extent of minutes of their meetings in executive session meetings. While the nature of an “executive session” meeting usually means that members of the management team should be excluded,⁶ the general counsel could train an independent director on how best to memorialize the content of executive session meetings.

To a similar degree, the general counsel can bring significant value to the heretofore minimized practice of drafting agenda and board resolutions. To be certain, there is only so much flexibility offered to the general counsel in applying legal advice to these tasks. The agenda is properly the principal province of the chief executive officer and the board chairman, while a resolution is exactly what was adopted by the board; neither presents much of an opportunity for “creative writing.”

Nevertheless, a general counsel can contribute significantly to both tasks. To the extent that a written agenda provides a summary of the topics to be addressed at a board meeting, it can provide meaningful evidence of what was discussed, and of the awareness and prudence of a governing board. In that sense, it can be a powerful evidence of the board's diligence and good faith. The input and advice of the general counsel can be particularly valuable in monitoring the appropriate use of such potentially problematic devices such as the “consent agenda,” in which, for the sake of efficiency, certain (presumably routine) matters are approved in mass without board discussion. Input can also be applied in referencing within the agenda (or an attachment thereto) the experts and advisors attending the meeting, and major reports and other documents provided to directors in advance of the meeting.

The board resolution completes (along with agenda and minutes) the initial “triple play” defense to scrutiny from plaintiff's/regulatory action. Certainly the recitals, but most particularly the text of the actual decision of the board, can provide clear and unequivocal evidence of a board or committee's action. The corporation/board/committee benefits from drafting by the general counsel, who will be sensitive to the most effective yet accurate manner by which the board's action is memorialized. Directing the general counsel to catalogue and periodically monitor compliance with such resolutions (where the action itself calls for follow-up) can provide useful protection against allegations that the corporation/board failed to pursue the action contemplated in its own resolutions (although such monitoring will impose an additional duty on the office of the general counsel, and thus may entail the need for additional resources for that office).

Along the same lines, the general counsel should be regularly consulted by board leadership and senior management on the specific information to be presented to the board for its consideration (e.g., reports, agreements, opinions) and the manner in which such information is conveyed (e.g., full text or “plain English” summaries). With the focus in so many governance controversies on the ability of the board to make an informed decision as to a particular matter, greater attention must be placed on the manner, timing and for-

⁶ See, e.g., Cheek Report, 59 BUS. LAW. At 178-179 (Item 2, Recommended Corporate Governance Practices).

mat through which information is provided to the board. For example, is a board best served by being provided in advance with an entire transaction document or thick set of financial projections, or with plain-English yet accurate summaries thereof? The expertise of the general counsel can be valuably applied in addressing important issues relating to information flow to the board from both the perspectives of enhancing deliberations and of managing litigation risk.

Attorney general “business compliance reviews,” IRS audits, the gradual yet noticeable increase in nonprofit derivative actions and other third-party scrutiny of corporate operations often focus closely on the books and records of the corporation and of its board. The failure to satisfactorily maintain these documents in an easily accessible format can lead to expensive internal self-discovery efforts or weakened defenses to external challenges. These risks can be minimized by assigning to the office of the general counsel more direct responsibility for maintenance of monitoring access or demands to, minutes, financial records, compensation analyses, professional opinions and audit letters and similar documents—whether in writing or electronically stored.

All of this is not intended to diminish the role, function and value of the professionally trained corporate secretary. Rather, it is to recommend greater involvement/assistance of the general counsel in the performance of traditional corporate secretary duties, whether or not the general counsel holds both positions.

Serving as Committee Staff

Sarbanes-Oxley rules, developing state statutes, increased IRS scrutiny and emerging “best practices” are combining to funnel nonprofit board committee practices within more carefully defined structures. These corporate responsibility developments have most certainly added additional legal burdens to committee operations. This is particularly the case with such key committees as audit, governance/nominating, executive compensation and compliance. While several “best practices” standards would allow these committees to engage outside counsel where necessary, appointing the general counsel to serve as “staff” to these committees offers an efficient, lower-cost compliance alternative in those situations where there is no overriding reason to require outside counsel.

With respect to the Audit Committee, the general counsel can be of assistance in addressing such important questions as the proper scope of the committee charter, committee member independence, the requisite degree of committee member financial literacy, terms and conditions (and management) of the auditor’s engagement, auditor independence concerns, and proper response to “whistleblowing” complaints and ethical disclosures by corporate counsel required to be directed to the Audit Committee.

The Governance/Nominating Committee would benefit from the general counsel’s regular involvement and advice on matters such as evolving standards of director conduct, a definition of independence, nomination/qualification standards, director “change in status” procedures, expectations of directors, the appropriate extent of outside board service, and similar topics with clear legal implications.

A related topic on which the impact of the general counsel would be particularly valuable is conflicts of interest management—which has dramatically increased in importance in the corporate responsibility environment. The general counsel could advise the Governance/Nominating (or other applicable) Committee on such important matters as (a) the continued effectiveness of the conflicts questionnaire; (b) issues raised by individual responses thereto; (c) processing and evaluation of disclosed potential conflicts; and (d) dealing with director conduct and participation when an actual conflict is determined to exist.

The Compensation Committee could also benefit from staff involvement of the general counsel. This is particularly the case given the emergence of specific “best practices” governing the role and function of this committee, as well as the intensive current focus of the Internal Revenue Service on executive compensation practices of nonprofit, tax-exempt organizations. The general counsel’s input could be particularly useful in addressing such important issues as qualification for the “rebuttable presumption of reasonableness,” the independence of committee members, the effectiveness of the committee charter, Form 990 strategy, the relevance of the work of the compensation consultant, and similar matters.

Involvement of the general counsel in the work of the Compliance Committee is uniquely important. Under the Cheek Report principles, the general counsel should have primary responsibility for assuring the implementation of the corporate compliance system and should be the board’s primary information resource concerning the legal compliance risks affecting the corporation.⁷ Regardless of the participation of a separate corporate compliance officer (whether or not a lawyer), many of the compliance issues to be considered by a compliance committee are inherently legal in nature and those that are not may yet have legal implications if not properly responded to. While there are many reasons why a separate compliance officer may be desirable, involvement of the general counsel in the work of the compliance committee can reduce related risks, can enhance horizontal communication with the compliance officer, and can also educate the general counsel as to the existence of legal concerns of which he/she may previously have been unaware.⁸

Advising on Advisors

The general counsel’s organizational duties might also be profitably expanded to advising the board and/or board committees on the selection of advisors whose expertise/work product is implicated by corporate responsibility considerations. These unique considerations include, for example, the independence of the consultant, unique qualifications mandated by law, the potential for conflicts of interest, the process which the consultant must follow in pursuing its engagement, the format and extent of opinions and other deliverables, the ability of the consultant to serve as an expert wit-

⁷ See Cheek Report, 59 BUS. LAW. at 160-161.

⁸ See, e.g., “An Integrated Approach to Corporate Compliance: A Resource for Health Care Boards of Directors,” Office of Inspector General, Department of Health and Human Services/American Health Lawyer’s Association (July, 2004), <http://org.hhs.gov/fraud/docs/complianceguidance/Tab%204E%Appendx-Final.pdf>

ness or otherwise testify in support of its conclusions, application of the attorney-client privilege, and the consultant's willingness to adhere to specific legal requirements in applying its analysis.⁹

In particular, in connection with the retention of independent auditors, the general counsel should be directly involved in negotiating the auditor's engagement letter from the perspective of such important matters as the process by which the auditor would propose to disclose to the corporation what it perceives to be actual or potential fraud, its own exculpatory protections and the scope of representations and warranties to be requested from senior management. The general counsel may also be helpful in assisting the Audit Committee in evaluating any potential conflicts arising between the audit engagement and other engagements involving the same firm and in documenting appropriate deliberations concerning such potential conflicts.

It is similarly critical for the general counsel to be involved in the selection of any executive compensation consultant, given the enormous current level of IRS scrutiny in this area. The carefully prepared report and related opinion of an experienced compensation consultant can form a crucial basis for application of the rebuttable presumption of reasonableness and similar legal defenses. However, as recent nonprofit controversies indicate, less-than-specific compensation consultant analyses may provide a false sense of security. The general counsel's appreciation for the nature of advice that will provide the basis for meaningful legal defense can be useful in the board's engagement of a compensation consultant.¹⁰

The general counsel's advice should also be sought in the selection of a professional firm sought to provide a valuation, fairness opinion or similar determination of financial/economic value. To a large degree, the work of such a consultant is directed by specific legal principles, e.g., the IRS valuation methodologies, Medicare/Medicaid rules regarding illegal remuneration, and corporate laws relating to the attributes of value. The general counsel may also advise as to the limitations as to the proper scope of engagement, e.g., judicial or administrative rulings and observations regarding conflicts of interest of firms that conduct valuations, broker transactions on a success-fee basis and issue fairness opinions with respect thereto.

Finally, there may arise circumstances in which the board or its committees feel the need to engage independent outside counsel. Although emerging concepts of "independence" suggest a limited role for the general counsel in such engagement, the general counsel can still provide meaningful advice to the board and its committees on issues ranging from prior connections between particular law firms and the corporation to specific areas of expertise offered by particular firms. It is a common, but frequently expensive, error for directors to focus on a law firm's general reputation without

adequate consideration of its particular specialized resources with respect to the particular engagement. Knowledgeable general counsel can help ensure a more effective engagement where independent counsel are to be brought in.

Director Fitness

A controversial, but nevertheless potentially valuable, use of the general counsel is to advise the Nominating/Governance Committee on matters relating to director fitness. This subject involves a list of factors related to a director's ability to serve and the quality of his/her service.

For example, the general counsel's input should be sought in the development and application of director nomination criteria. In the current environment, state charity officials have placed greater focus on the fundamental qualifications of individuals to serve on the governing board of a nonprofit corporation, particularly one that is organizationally or structurally complex and/or sophisticated in terms of revenues/financial resources. The general counsel can provide meaningful assistance on the development of nominating criteria that help assure the maintenance of an appropriately diverse board from the perspective of necessary expertise, bearing in mind developing guidance from regulatory authorities that may not have come to the attention of the board.

Most of the corporate governance "best practices" compilations are strongly supportive of enhanced board education and self-evaluation processes. The general counsel may appropriately advise on the sufficiency of these processes under, and their consistency with, best practices and more specific requirements. The general counsel should logically have greater input into the board education programs of more regulated nonprofits in order to assure that the directors are receiving an appropriate degree of education concerning legal developments of relevance to their service.

Along the same lines, the general counsel can provide valuable guidance with respect to navigating the board through expressed concerns of state charity officials as to precisely how the board education budget is spent and related accounting. Some such officials have been outspoken (and, arguably, excessive) in their criticism of the board educational activities of nonprofit organizations (e.g., extended attendance at professionally developed seminars held at "luxury resorts"). The income tax implications to directors (and their spouses) of participation in such education forums also merits the advice of the general counsel.

Conclusion

The Sarbanes-Oxley Act and the resulting corporate responsibility environment continue to have an unmistakable impact on nonprofit corporations "of all stripes." These implications are most clearly felt in the development of new rules, regulations and standards of conduct related to the governing board's fundamental oversight obligations. As the vast majority of these developments are fundamentally based in law and/or legal principles, it is only natural for the board to turn to its general counsel for related advice. Indeed, the scope of this corporate responsibility spillover merits close board consideration to a formal expansion of the role of the general counsel to include provision of advice on these matters. Such a decision would be entirely consis-

⁹ See, e.g., Peregrine, Cotter & DeJong: "New 'EO' Focus: The Board Compensation Committee," *The Exempt Organization Tax Review*, March, 2004.

¹⁰ See, e.g., Stipulation and Order for Appointment of Special Administrator, *In the Matter of HealthPartners, Inc.*, a Minnesota Charitable Trust, and Group HealthPlan, Inc. (d/b/a Group Health, Inc.), a Minnesota Charitable Trust, State of Minnesota, County of Hennepin (Court File No. ML 03-001587), June 10, 2003.

tent with (a) emerging corporate governance “best practices” on the role of the corporate general counsel, and (b) the increasingly popular trend among major corporations to establish a position of “Chief Governance Officer,” and to assign the General Counsel to also assume the related duties of that position. Admittedly, such a decision may entail the necessity of providing additional resources—in terms of both funds and personnel—to the office of general counsel to ensure that these enhanced duties can be effectively carried

out. Further, such a decision may pose political challenges, as it requires the board and executive management team to re-think the traditional role of the general counsel and expand the powers—and perceived “independence”—of the general counsel. However, the many potential benefits of thoroughly engaging the skills of the general counsel in the board’s fulfillment of its oversight duties should justify any additional costs, both fiscal and political.