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**SECOND GENERATION “BEST PRACTICES”
SEEN IN PANEL ON THE NONPROFIT SECTOR RECOMMENDATIONS**

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On October 18, 2007, in a significant corporate governance development, the influential Panel on the Nonprofit Sector released the publication, *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* (“Principles”).¹ In the Principles document, the Panel presents 33 concepts of “sound practice” recommended for consideration by every nonprofit, charitable organization as a guide for strengthening its effectiveness and accountability. The Principles are particularly worthy of note by hospital and health system leadership because they (a) address concepts beyond those that emerged in the wake of Sarbanes-Oxley (*i.e.*, they are “second generation” in nature); and (b) are emerging during a period of unprecedented legislative, regulatory, and media focus on the corporate governance of nonprofits.

“Best practices” and similar governance principles are aspirational goals, and do not have the force of law. A board’s failure to pursue best practices does not necessarily constitute breach of fiduciary duty. However, the consideration and adoption of such principles of good governance are likely to be considered by courts and regulators as evidence of the board’s exercise of good faith, and thus can serve an important prophylactic role whenever board conduct is in question.

¹ Available at http://www.nonprofitpanel.com/selfreg/Principles_Guide.pdf.

I. Overview

Of the 33 principles, six describe actions that all charitable organizations must take pursuant to applicable law. The remaining 27 principles describe actions that such organizations should strongly consider adopting, based upon their organizational and operational structure and charitable mission. In particular, the 33 individual principles are organized under four main categories:

Legal Compliance and Public Disclosure: responsibilities and practices intended to assist charitable organizations with legal compliance and in effecting transparency with the public;

Effective Governance: policies and procedures to be adopted by boards in order to support oversight obligations and enhance efficient governance;

Strong Financial Oversight: policies and procedures designed to support the prudent oversight of charitable assets; and

Responsible Fundraising: policies and procedures recommended as a means by which nonprofit organizations may develop donor support and confidence in their charitable solicitation activities.

In so doing, the Principles suggest consideration of a governance framework for charitable organizations that goes beyond compliance with basic Sarbanes-Oxley concepts. This is particularly the case with respect to specific recommendations relating to board structure, independence, financial oversight, constituent transparency, and oversight of charitable solicitation activities.

II. Intended Use

The Panel on the Nonprofit Sector recommends that charitable organizations examine the 33 separate principles and consider how best they may be applied to their own operations and existing governance provisions. This is a process that may efficiently be conducted within the confines of a board committee (e.g., the governance committee), which could conduct the necessary analysis and report its related

recommendations to the full board. An example of such an approach was the extensive work conducted earlier this year by the Governance Committee of the Smithsonian Institute (an IRC Sec. 501(c)(3) charity) which, with the help of Panel on the Nonprofit Sector leaders, compared existing Smithsonian board practices against emerging principles of corporate governance in a dramatic and much-lauded restructuring of corporate governance.²

III. What's New and Distinctive

Most prudent and responsible boards of nonprofit hospitals and health systems have adopted some semblance of governance policies and procedures in years following enactment of Sarbanes-Oxley. For some institutions, these policies were limited to those that addressed core Sarbanes concepts of audit committee oversight, financial integrity, and financial transparency. Other, more proactive institutions also addressed more extensive issues relating to the organization and operation of the board. Yet, for all types of institutions, the Principles contribute a series of new, distinctive ideas and recommendations to the corporate responsibility dialogue that are worthy of consideration by boards and their governance committees. These include the following:

Principle #3: *A charitable organization should adopt and implement policies and procedures to ensure that all conflicts of interest, or the appearance thereof, within the organization and the board are appropriately managed through disclosure, recusal, or other means.* This Principle serves a useful purpose by reminding boards that conflicts resolution may, by nature, be flexible; i.e., while some conflict of interest transactions may be illegal, unethical, or inappropriate, others may be capable of being approved, as in the best interests of the organization (as long as clear procedures are followed). The keys to an effective process are timely and complete disclosure of potential conflicts, and a transparent review process in which board members are able to understand the nature of the conflict and whether it can be appropriately managed.

² See, e.g., "Report of the Governance Committee to the Board of Regents," June 14, 2007, available at http://www.newsdesk.si.edu/releases/Governance_Committee_Report.pdf.

Principle #6: *A charitable organization's board should ensure that the organization has adequate plans to protect its assets.* This Principle indirectly endorses the concept of "enterprise risk management" as a proper topic for formal board attention. It concludes that boards are responsible for understanding the major risks to which the organization is exposed, reviewing those risks on a periodic basis, and ensuring that systems are in place to effectively manage those risks. Many nonprofit hospitals and health systems have long maintained components of such a strategy (e.g., corporate compliance plans, insurance covering key assets, quality of care oversight, technology backup, asset insurance, and indemnification and insurance protection for officers and directors). By this principle, however, the Panel describes additional components of enterprise risk management and encourages boards to evaluate risk mechanisms from a more global perspective.

Principle #7: *A charitable organization should make information about its operations, including its governance, finances, programs and activities, widely available to the public.* This Principle stresses the importance of organizational and operational transparency and encourages its practice to a level perhaps beyond that which many nonprofits have previously occupied. Suggested elements of transparency include website access to the organization's annual report, the annual Form 990, financial statements, vision and mission statements, lists of board and staff members, statements of values and codes of ethics, and policies on conflicts of interest, whistleblower protection, and travel expense reimbursement. Such a degree of transparency would likely be favorably viewed by state and federal charity regulators.

Principle #11: *The board of a charitable organization should include members with the diverse background (including, but not limited to, ethnic, racial and gender perspectives), experience, and organizational and financial skills necessary to advance the organization's mission.* This Principle expands the focus on desired board diversity beyond traditional concepts of community leadership, business and financial acumen, and health industry experience to include concepts of ethnicity, race, and gender. This new emphasis on cultural diversity in the boardroom is consistent with the requirements for board composition contained in the controversial draft proposal on hospital tax-

exemption standards submitted by staff to the Senate Finance Committee earlier this year.

Principle #12: *A substantial majority of the board of a public charity, usually meaning at least two-thirds of the members, should be independent.* This particular Principle will serve to increase the focus on director independence as a governance issue separate and distinct from conflicts of interest. It also serves to emphasize the need to reconcile separate and potentially inconsistent concepts of board/committee member independence under provisions of corporate/governance law and practice, and federal tax law (e.g, the “Community Benefit Standard” for tax-exempt status mandates that the board be controlled by community leaders). From a broader perspective, this Principle will likely be controversial, as many nonprofits can be expected to struggle to implement a two-thirds standard of independence. This Principle will also increase the policy debate on the definition of “independence” as it applies to the nonprofit director, and the importance of maintaining board and key committee control in independent directors.

Principle #13: *The board should hire, oversee and annually evaluate the performance of the chief executive officer of the organization.* This Principle reinforces several aspects of sound practice with respect to board determination of reasonable executive compensation: (a) regardless of the role and efforts of the compensation committee, the full board should be required to review the performance and approve the compensation of the CEO annually in advance of any change in compensation; (b) the compensation committee should consist of independent members; (c) the compensation consultant engaged by the board should similarly be independent; (d) it is acceptable to consider data from comparable tax-exempt and taxable corporations in determining reasonable executive compensation; and (e) the board/compensation committee should also review the overall compensation program of the organization.

Principle #16: *Board members should evaluate their performance as a group and as individuals no less frequently than every three years, and should have clear procedures for removing board members who are unable to fulfill their responsibilities.*

This Principle will likely prompt boards to (a) consider more closely the detail and effectiveness of self-evaluative practices and procedures, (b) adopt more detailed guidelines of the duties and obligations of each member; and (c) expand the director removal process, including consideration of related provisions, such as enhanced obligatory disclosure, and “automatic resignation” upon the occurrence of certain events that call into question the integrity, or the continued fitness to serve, of individual directors. Thus, this Principle may be used by the board to resolve existing and expected difficult political issues involving individual directors.

Principle #19: *The board should establish and review regularly the organization’s mission and goals and should evaluate, no less frequently than every five years, the organization’s programs, goals and activities to be sure they advance its mission and make prudent use of its resources.* This particular principle speaks to the basic, but often underappreciated, fiduciary concept of duty of obedience to corporate mission; *i.e.*, the obligation of the board to assure that its decisions are consistent with, and in support of, the charitable mission of the organization. This is an extremely important concept in nonprofit healthcare, given (a) the repeated comments by senior IRS officials concerning a “blurring of the line” between the tax-exempt and commercial sectors (particularly in healthcare), and (b) the current policy debate on charity care and community benefit, at both the federal and state levels.

Principle #20: *Board members are generally expected to serve without compensation, other than reimbursement for expenses incurred to fulfill their board responsibilities.* Despite the fact that this particular Principle was softened through the drafting process, it nevertheless reflects a basic bias against compensation of nonprofit directors. This Principle is likely to be controversial, because the nonprofit laws of many states either directly authorize, or at least are silent on, the payment of reasonable compensation to directors. Even so, this Principle is supportive to the extent that it speaks to the standards that can be used to support such compensation when provided: appropriate comparability data, documentation of underlying decision, and full disclosure of the amount of and rationale for the compensation, to any interested party.

Principle #22: *The board of a charitable organization must institute policies and procedures to ensure that the organization (and, if applicable, its subsidiaries) manages and invests its funds responsibly, in accordance with all legal requirements.* This Principle serves as a useful reminder to the board regarding the importance of their stewardship role with respect to the management of investments. This is particularly the case with volatile financial markets, the availability of high-risk/reward investment vehicles, and the emergence of new uniform laws governing the prudent investment of institutional funds held by charitable organizations.

Principle #26: *A charitable organization should neither pay for nor reimburse travel expenditures for spouses, dependents or others who are accompanying someone conducting business for the organization unless they, too, are conducting such business.* This Principle will be viewed favorably by many compensation committees, general counsel, and compliance officers called upon to address politically sensitive issues regarding travel expense reimbursement. This Principle essentially puts another “nail in the coffin” of the increasingly discredited practice of reimbursement of spousal expenses, particularly given the difficulty in identifying a legitimate business purpose for most types of spousal travel.

Principles #27-33: These are a series of “Responsible Fundraising” recommendations that place particular emphasis on important issues such as (a) charitable solicitation and donor communications; (b) assurance that contributions will be used consistent with donor request; (c) providing donors with specific acknowledgements of charitable contributions; (d) the adoption of policies governing the basis for rejecting proposed donations, on ethical, financial circumstances, program focus, or other grounds; (e) provision of appropriate training for, and supervision of, organizational staff involved in charitable solicitation/management of institutional funds; (f) appropriate compensation methodology for fundraisers (external or internal); and (g) controls with respect to donor privacy. These are all issues that have been the subject—both individually and collectively—of substantial legal controversy within the nonprofit sector in recent years, yet have not historically been included within “best practices” compilations. Most nonprofit hospitals and health system boards are unlikely to have

adopted such controls, but should consider doing so if they are involved in charitable solicitation activities to any significant degree.

IV. The Relevance of the Environment/Why We Should Care

The Principles emerge in a period of unprecedented scrutiny of the business and operations of nonprofit corporations. Legislatures and regulators both have expressed concern that the governance practices of nonprofit, charitable organizations must be improved in order to address issues related to abuse and mismanagement of charitable assets. A related concern is that existing statutes and regulations may be insufficient to provide effective oversight of nonprofit organizations (especially those that are structurally and/or financially sophisticated). The nonprofit sector continues to suffer from high-profile governance controversies, such as those experienced this year by The American Red Cross and the Smithsonian Institute. The IRS is making nonprofit governance a “pillar” of its compliance initiative for tax-exempt organizations, and state charity officials are dramatically increasing the extent to which they both regulate nonprofits and refer cases involving nonprofit governance to the IRS. What all this serves to demonstrate is that the attention and focus on nonprofit governance is increasing and that it is likely to remain as a basic legal feasibility issue. Boards and their governance committees should thus expect to continue to be attentive to evolving governance standards in the future.

V. About the Panel

The Panel on the Nonprofit Sector is an independent activity created by leading charities and foundations to help assure a continuing role for the nonprofit community in American society. The Panel was convened by The Independent Sector in 2004, at the encouragement of the U.S. Senate Finance Committee. It is comprised of 24 nonprofit and philanthropic leaders, whose organizations reflect substantial diversity in size, scope, and charitable purpose. Prior to the release of the Principles, the Panel published two separate reports (in 2005 and 2006) to Congress and the nonprofit sector, “Strengthening Transparency, Governance and Accountability of Charitable Organizations” (“Final” and “Supplemental” reports).

VI. Evolution Into Best Practices

The prominence of the Panel’s individual membership, the breadth and depth of its work product, and the support it has received from Senate leadership combine to suggest that the Principles be regarded as a significant contribution to nonprofit corporate governance discourse. Indeed, for these and other reasons, it is conceivable that over time, the Principles may evolve into the state of *de facto* governance best practices for the nonprofit sector. In this role, it is likely that they may not only be considered as a resource for nonprofit organizations, but applied as standards of conduct by courts and regulatory agencies evaluating the governance and business practices of nonprofit organizations. Accordingly, the Principles are worthy of consideration by all nonprofit, charitable organizations, regardless of industry group, financial size, or organizational sophistication.

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