

## Keeping Your Board Above Board

**The Sarbanes-Oxley Act sets strict new rules for corporate directors. Can nonprofit boards hold themselves to a lesser standard?**

*By Patrick K. O'Hare*

Recent cases of lax corporate governance, questionable accounting and criminal fraud have driven Congress to pass the most far-reaching corporate accountability and accounting reform legislation in decades. Signed into law on July 30, the Sarbanes-Oxley Act of 2002 will subject public companies in the United States to a slew of tight new governance requirements.

Even though nonprofit organizations are not legally subject to the provisions of Sarbanes-Oxley, they are bound to feel its effects—either because states (especially those that have seen notorious nonprofit bankruptcies and other scandals involving nonprofits) will move to duplicate or extend some of the provisions, or because state attorneys general will impose them as part of charitable-entity reporting or charitable-trust enforcement actions, or because insurers will demand compliance, or because nonprofit managers and directors will emulate them on their own in order to maintain donor and constituent confidence.

Several of the Sarbanes-Oxley governance provisions are more likely than others to migrate to the nonprofit arena, including those dealing with the board's audit committee, certification of financial statements, compensation of senior executives, financial officers' code of conduct, and enforcement powers to remove unfit directors.

The legislation requires public corporations subject to the act to create audit committees "directly responsible" for retaining and supervising outside auditors. Audit committee members must be independent, meaning that the chief executive officer, chief financial officer, and other senior management personnel cannot be members. As part of this "independence" standard, audit committee members may not be paid for consulting or other services provided to the corporation outside of their service as directors.

The corporation must also disclose whether the audit committee has at least one member who is a "financial expert"—and if not, why not. Finally, the committee must establish procedures for receiving whistle-blower complaints

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about the company's accounting practices.

If nonprofits fail to adopt comparable procedures, they will appear to be more laxly governed than their for-profit peers. Therefore, nonprofit boards without an audit committee should consider the merits of creating one voluntarily, and nonprofit boards that do already have an audit committee already should consider removing senior management or "interested" directors (e.g., those whose firms also provide legal, banking, consulting or other professional services to the corporation). Conforming bylaw changes should also be made, and insurance coverage should be examined to ensure that committee members with these added responsibilities are protected.

In one key provision (that goes well beyond the SEC's recently proposed rule on financial statement certification) Sarbanes-Oxley requires "that the principal executive officer...and the principal financial officer...certify in each annual...report" as to the following: that they have reviewed the report; that the report "does not contain any untrue statement of a material fact" or a material omission; that the financial statements fairly present the financial condition of the corporation; that the certifying individuals have designed and evaluated systems of internal controls to make sure that they are aware of material information concerning the corporation's operations; and that the signers have disclosed to the company's auditors and audit committee any deficiencies in the controls as well as any fraud involving management or other key employees.

Full disclosure and, more importantly, implementation of procedures to ensure accurate reporting, have thus become the "gold standard" against which all corporations will be measured. For nonprofits, a comparable form of certification, along with the creation and assessment of internal controls to ensure accurate reporting, may be required in order to maintain credibility with donors. Moreover, given the increased public scrutiny and regulation of accounting firms, nonprofit entities may be required to give system certification representations to their auditors as part of the annual audit.

Sarbanes-Oxley also prohibits, with certain exceptions, personal loans from the corporation to "any director or executive officer." (Existing loans are grandfathered.) Although current tax exemption principles speak to the terms of such loans where a state's nonprofit code allows them—and not all states do—this provision goes further and prohibits them entirely. Senior executive compensation packages involving such incentives—say, for the purpose of recruiting a new CEO relocating to an area with high housing costs—should be avoided by nonprofits, since they will now be harder to

justify when compared to compensation practices in the for-profit sector.

Sarbanes-Oxley also directs the Securities Exchange Commission to promulgate rules requiring corporations subject to the act to disclose whether they have adopted "a code of ethics for senior financial officers" (and if not, why not). Again, this provision will almost surely become a "gold standard," putting non-adopting corporations—as well as nonprofits that fail to adopt a comparable code of conduct—in a negative light in the eyes of their constituencies, the media, and insurance companies that cover them for directors and officers' liability.

Finally, the legislation gives to the SEC the power to remove directors for "unfitness." (The previous standard was "substantial unfitness.") Occasionally in the past, state attorneys general have sought the removal of directors of a nonprofit corporation in proceedings brought to enforce charitable trusts. Now the remedy may be sought more frequently, given the modification of the standard for public companies.

Boards of charitable foundations and nonprofit organizations would be well-advised to become familiar with all of the governance provisions contained in Sarbanes-Oxley. They should decide if it is better to be proactive and adopt some or all of these new standards now, or risk the consequences of delay by waiting until regulators, insurers, or the marketplace demand it of them.

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