



JONES DAY
COMMENTARY

BEST PRACTICES IN NONPROFIT GOVERNANCE: DEALING WITH “VOLUNTARY” REFORMS

Nonprofit governance reform was a focal point in the last Congress and may become one again. In the meantime, however, a recent IRS pronouncement may serve as a catalyst for voluntary reforms. On February 2, 2007, the IRS released its “Good Governance Practices for 501(c)(3) Organizations” (the “Recommendations”), calling on charities voluntarily to implement “best practices” for corporate governance. Although the IRS does not have the authority to regulate nonprofit governance directly, several of the tax rules the IRS does enforce (e.g., private inurement, private benefit, and excess benefit rules) contain concepts that parallel state-law fiduciary duties, including the duty of loyalty and the duty of care. Moreover, in order to facilitate IRS enforcement activities, both Form 990 (annual information return) and Form 1023 (exemption application for 501(c)(3) organizations) require a wide variety of disclosures regarding financial transactions with insiders, including the process followed in approving insider transactions. Both Form 990 and Form 1023 are public documents, with most Forms 990 and some Forms 1023 readily available online.

Therefore, while the Recommendations are not mandatory standards, they do reflect the kinds of processes that will make the IRS comfortable when it looks at financial arrangements with insiders for potential private inurement, private benefit, and excess benefit abuses. State attorneys general investigating nonprofits will also likely consider the extent to which organizations have implemented the Recommendations, and the media, private interest groups, and private litigants are likely to compare an organization’s behaviors with the Recommendations and call to task any organization that is perceived as falling short. As a result, we believe the IRS Recommendations merit careful consideration by all exempt organizations.

IRS BEST PRACTICES FOR NONPROFIT GOVERNANCE

The governance practices outlined in the Recommendations are based in significant part on actual and potential abuses uncovered by the IRS in audits, exemption applications, and compliance checks. The Recommendations, outlined in more

detail below, cover potential areas of concern that may raise fiduciary-duty issues and can affect the efficacy of nonprofit governance.

Board Composition. The IRS did not articulate any precise formulation for board size or composition. However, it did express concern over boards that are either too small or too large, noting that “[s]mall boards generally do not represent a public interest and large boards may be less attentive to oversight duties.” The Recommendations also state that “successful” boards include not only individuals who are “knowledgeable and passionate about” their organizations’ activities, but also those with expertise in key areas such as accounting, finance, compensation, and ethics. Although these are arguably sound as general principles, the unique circumstances of different charities may merit different approaches to board composition. The IRS also suggests that organizations with larger boards establish appropriate committees. Such organizations also should address potential quorum problems for the board in the corporate bylaws.

Duty of Obedience to Mission. The IRS suggests that charities create a “clearly articulated” mission statement. The mission statement should communicate why the organization exists, what its objectives are, whom it is intended to benefit, and what activities it will undertake to further its mission. Understanding the mission is essential in being able to fulfill a director’s fiduciary duties. In that regard, the duty of obedience requires directors and officers to act with fidelity, within the bounds of the law generally, to the corporation’s mission and purposes as expressed in its articles of incorporation and bylaws.

Code of Ethics and Whistleblower Policies. The IRS encourages charities to develop and regularly evaluate a code of ethics that describes behaviors it encourages and discourages. This general concept may best be understood as fostering an overall culture of compliance, consistent with the fiduciary duty of directors to ensure that charitable organizations satisfy applicable legal requirements. The Recommendations also encourage charities to adopt effective whistleblower policies, at the same time that Congress has increased the reward for tax whistleblowers to up to 30 percent and the IRS established a Whistleblower Office to respond to allegations of tax abuse in excess of \$2 million (though recent legislation would lower that threshold to \$20,000). It is important to note that various state and federal laws also provide protections for whistleblowers and require certain health-care providers to provide information to potential whistleblowers about state and federal false claims acts and whistleblower protections.

Duty of Care and Exercising Due Diligence. The Recommendations also call upon directors to “exercise due diligence” in reviewing transactions in order to fulfill their duty of care. The Recommendations define the duty of care as requiring directors to act in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner that the director reasonably believes to be in the charity’s best interests. Consistent with the overall objective of establishing a culture of compliance, the IRS encourages directors to adopt policies and procedures to ensure that all directors are familiar with the organization’s activities (how they further its mission and goals), that they are fully informed about the organization’s financial condition, and that they make informed decisions based on full and accurate information. As part of their duty of care, directors and officers must take steps to ensure that they are reasonably informed about key aspects of all significant transactions, including both economic and mission effects of the transaction. Questions about the level of due diligence and board oversight have arisen on audit, particularly with respect to compensation packages and major transactions such as joint ventures.

Duty of Loyalty and Avoiding Conflicts of Interest. The duty of loyalty requires faithful pursuit of the interests of the corporation rather than the director’s own financial or other interests or those of another person or organization. Not all dualities of interest, however, are conflicts of interest that implicate the duty of loyalty. As the Recommendations note, this duty obligates directors to avoid conflicts that would be detrimental to the charity. To address that obligation, the IRS suggests two key steps. First, adopt and regularly evaluate (for effectiveness) a conflicts-of-interest policy that requires directors and staff to act solely in the interests of the charity without regard to personal interests, includes written procedures for determining whether a duality of interest constitutes a conflict of interest, and outlines specific actions to be taken if a conflict is identified. Second, require annual written disclosures of any personal, financial, or business duality of interest. This focus on conflicts is consistent with the release of a model conflicts-of-interest policy by the IRS in July 1996 (now included in the Instructions to Form 1023). Although adopting a conflicts policy is not required by federal tax laws, organizations that fail to do so may find their exemption applications delayed or may even be targeted for an early audit. Adopting and following a conflicts policy also can have some tax advantages for an organization in that the absence of conflicts by an approving board or committee is one of the requirements for establishing a rebuttable presumption of reasonableness of a transaction (a key defense against excise-tax liability for potential excess benefit transactions).

Promoting Transparency. The IRS suggests a charity demonstrate transparency by “making full and accurate information about its mission, activities, and finances publicly available.” By way of example, the Recommendations suggest that charities post their Forms 990 online as well as annual reports and financial statements. Templates for community benefit reporting published by CHA and the AHA also can be a helpful part of transparency. There are some limits to transparency, however. For example, it may be reasonable for organizations to conclude that some information not required on Form 990 needs to remain confidential (e.g., strategic planning objectives). Recent revisions to Form 990 already have substantially increased the disclosures required of charities, including all compensation paid to former directors, officers, and key employees (regardless of when they left the organization); compensation paid to independent contractors for other than professional services; compensation paid through more loosely related organizations; family and business relationships among officers, directors, key employees, and top-paid employees and independent contractors; allocation of compensation among program services, management, and fundraising; loans to former officers, directors, key employees, and other disqualified persons; the number of directors and officers permitted to vote on compensation; adoption of a conflicts-of-interest policy; and transfers to and from controlled entities. Charities are also now required to publicly disclose their Forms 990-T (reporting unrelated business income).

Monitoring Professional Fundraisers. The IRS recommends that charities adopt and monitor policies to ensure that fundraising solicitations satisfy federal- and state-law requirements (which also may require the charity itself to register and file certain reports). Consistent with its past concern over amounts paid for fundraising services (see *United Cancer Council, Inc. v. Commissioner*), the Recommendations caution charities again to ensure that they pay no more than a “reasonable” amount for fundraising services.

Conducting Financial Audits. One of the responsibilities of a director is stewardship of corporate resources (and avoiding “waste” of charitable assets). The Recommendations reflect this responsibility by suggesting board oversight of expenditures to ensure that the charity operates within its approved annual budget. The Recommendations also encourage organizations of all sizes to conduct some level of financial review. For charities with “substantial assets or annual revenue,” the Recommendations favor hiring an independent auditor and suggest establishment of an independent audit committee to hire and oversee the charity’s audit firm. The IRS also recommends changing audit firms at least every five years to ensure “a fresh look at the financial statements.” The Sarbanes-Oxley Act, however, requires public

companies to rotate only their audit partners, not their audit firms. At the conference where the Recommendations were first released, the IRS acknowledged that the Sarbanes-Oxley Act requirement may make more sense for charities and, in the end, may better protect charitable assets. Accordingly, the IRS indicated a willingness to reconsider its Recommendation for the rotation of audit firms as opposed to audit partners. The Recommendations suggest that smaller charities engage a CPA to conduct an annual audit and that “very small organizations” at least review their own financial information and practices and perhaps swap volunteers with similar organizations to conduct this review. Sharing this information with such outside volunteers may raise antitrust and privilege concerns. The concept of sharing volunteers, however, may be useful in other respects, such as an exchange of good governance ideas during a periodic evaluation of governance effectiveness.

Limiting Compensation. The Recommendations encourage charities to adopt practices to ensure that all compensation paid for services is reasonable. Additionally, the IRS recommends that charities not offer any compensation to directors, other than the reimbursement of expenses directly associated with their services as directors. This “volunteer standard” is consistent with the exceptions on reporting compensation of volunteers from certain related organizations in Form 990, and with the requirements for volunteer immunity under many state laws. These Recommendations also follow on the heels of the IRS executive-compensation initiative, where the IRS discovered two key trends: approximately 95 percent of interested directors recused themselves from voting on their own compensation; and most organizations follow the rebuttable presumption procedure in setting compensation for disqualified persons. The Recommendations suggest following the rebuttable presumption procedure, but they fail to recognize that determining who is a disqualified person is often a subjective exercise of weighing the facts and circumstances, other than for voting directors, top officers and their family members, and 35 percent controlled entities (who are deemed to be disqualified persons).

Retaining Documents. The Recommendations also remind charities of their obligations to develop a document-retention policy (including handling of electronic files, backup procedures, archiving, and reliability checks). One reason for this recommendation is likely the number of organizations that have lost or been denied tax-exempt status for failure to produce corporate records to support expenditures, compensation, and various transactions and activities. The recommended recordkeeping suggestions are also consistent with the Sarbanes-Oxley Act, which made it a felony (punishable by a fine and up to 20 years in prison) to alter or hide corporate records with the intent to impair an investigation.

OTHER CONSIDERATIONS FOR GOOD GOVERNANCE

The Recommendations should not be viewed as the last word in good governance for nonprofit organizations in at least three important respects. First, the various fiduciary duties discussed by the IRS (duties of care, loyalty, and obedience) are traditionally state-law concepts. Accordingly, the scope of the duties and available protections (such as the business-judgment rule and reliance on officers, committees, and professional advisors) may vary from state to state. Second, to the extent that an organization functions in a heavily regulated industry, such as health care, a variety of state and federal regulations also affect the role and responsibilities of corporate governance. Third, certain specific activities of nonprofits in any industry, such as soliciting donations, have their own particular exposures and requirements.

The IRS noted that following the Recommendations is not a requirement for exemption, and in fact the IRS refrained from using the term “best practices,” calling these standards instead “good governance practices.” The IRS did note, however, that following some or all of these practices increases the likelihood that the nonprofit will be successful in carrying out its exempt purposes (which can be a key consideration on audit). That caveat sends a strong message to the charitable community that the IRS is serious with respect to ensuring that charities have strong corporate governance. Charities heeding that message may conclude at a minimum to take the following actions:

- Adopt a substantive conflicts-of-interest policy appropriate for the organization.
- Follow the rebuttable presumption procedure to the extent practicable.
- Provide education and training in compliance and corporate governance in-house or through local seminars.
- Conduct a periodic self-evaluation of governance effectiveness (board structure, reporting relationships, articles and bylaws, financial and mission accomplishments, etc.) either as a group, with cross-volunteers from other organizations, or with legal counsel or governance consultants.

Taking these steps without the pressure of mandatory standards will allow charities to use the Recommendations to strengthen their internal controls and enhance the charitable activities they conduct. By disclosing these reforms on Form 990 voluntarily, organizations also may be able to forestall some criticism and pressure for following a “one size fits all” approach.

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