

**Governance and Nonprofit Corporations:
Requirements and Expectations in a Post-Sarbanes-Oxley World**

A Primer for Directors and Management of Nonprofit Organizations

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I. INTRODUCTION

- A. **Corporate Governance - What is it?** “Corporate governance” refers both to the system of rules, policies, and procedures through which the board of directors of a corporation oversees its affairs and how the board actually performs its functions and discharges its duties.
- B. **Why Corporate Governance Has Become so Important.** In today’s environment, the quality of governance of a nonprofit corporation has emerged as a major concern because of the continuing high-profile failures of corporate leadership to oversee the activities of corporations and to meet minimum standards for responsible stewardship consistent with the best interests of the corporations and their members or shareholders, if any.
1. Recent scandals in the nonprofit and for-profit sectors have justifiably received relentless attention from the press and outraged the public, legislators, and regulators.
 - a. The Enron and WorldCom collapses immeasurably damaged their investors and employees and severely impaired public confidence in the reliability and trustworthiness of corporate boards and the integrity of financial statements and disclosures.
 - ◆ Executive compensation at a number of high-profile companies, including Enron, WorldCom, and, most recently, the New York Stock Exchange, has been perceived as wildly excessive.
 - ◆ The United Way of the Capital Area provided an example of excessive compensation in the non-profit arena.
 - b. These scandals are commonly believed to have been grounded in corporate cultures where boards abdicated their responsibilities and insiders treated the corporations as private fiefdoms for personal benefit.
 2. Even prior to the recent scandals, Congress and regulatory agencies were increasingly vigilant about perceived improper conduct of directors and employees of tax-exempt organizations.
 - a. In 1996, Congress passed the Intermediate Sanctions legislation, imposing penalty excise taxes on insiders who received “too much” from tax-exempt organizations.
 - b. As another example, the Internal Revenue Service (the “IRS”) increased its focus on insider transactions with organizations exempt under section 501(c)(3) of the Internal Revenue Code (the “Code”).

- ◆ In 1997, the IRS published a sample conflicts of interest policy, which it subsequently revised in 1999 (the “IRS Model Policy”). The IRS suggested that the existence of a comprehensive policy was a factor the IRS would consider favorably when it evaluated some issues. IRS EXEMPT ORGANIZATIONS DIVISION, CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM TEXTBOOK FOR FISCAL YEAR 2000, 48 (1999) (hereafter “2000 IRS TEXTBOOK”). A copy of the IRS Model Policy is attached.
 - 3. The public is increasingly intolerant of failures of governance, whether due to director negligence, inattention, malfeasance, or some other reason. The public in particular expects charitable and nonprofit organizations to be well run for the benefit of the public with a sustained focus on mission.
- C. **Sarbanes-Oxley.** Congressional displeasure with the performance of directors of publicly-traded companies and with their lack of sensitivity to conflicts of interest or the importance of independent audits led to the enactment of the American Competitiveness and Corporate Accountability Act of 2002, commonly known as the Sarbanes-Oxley Act (“the Act” or “Sarbanes”).
- 1. The Act applies generally only to publicly-traded companies and establishes requirements designed to ensure an effective and independent audit, including the requirement for an Audit Committee.
 - 2. The provisions of the Act are relevant to nonprofits in several ways:
 - a. The provisions of the Act concerning whistleblowers and document destruction do apply to nonprofits.
 - b. The requirements for publicly-traded companies are becoming the standards for best practices for nonprofits.
 - c. Some state attorneys general are proposing state versions of Sarbanes that are applicable to nonprofits.
 - 3. The Act now constitutes one part of the comprehensive set of principles and expectations for corporate governance and accountability for nonprofits.

II. STANDARDS OF CONDUCT AND DUTIES OF DIRECTORS

A. **General.** The directors of a nonprofit corporation have obligations and responsibilities to the corporation.¹ These duties are grounded in common law and state and federal statutes.

B. **Common Law Duties.**

1. **Duty of Care.** A director must be diligent and attentive to the corporation's affairs.
 - a. Directors must be (1) reasonably informed, (2) participate in decisions, and (3) do so in good faith and with the care of a prudent person in similar circumstances. AMERICAN BAR ASSOCIATION GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS, 19 (*GEORGE W. Overton and Jeannie Carmedelle Frey ed.*, 2002) (hereinafter "ABA GUIDEBOOK").
 - ♦ "Good faith" has been interpreted by the courts to mean that the director acts and makes decisions in the best interests of the corporation.
 - b. **Business Judgment Rule.** A director whose conduct meets this standard will generally not be liable for damages related to the director's actions. This is called the "business judgment rule."
 - c. Directors also should reasonably inquire about matters coming before the board. This aspect of the duty of care has recently been spotlighted; the Enron directors do not seem to have asked questions they should have asked.
 - d. Directors' obligations to establish compliance plans are grounded in the duty of care.
2. **Duty of Loyalty.** Directors must act in the best interests of the corporation, not in their own interests or the interests of another person or organization.
 - a. A director may not use his or her corporate position for individual personal advantage or take an opportunity available to the corporation and use it personally. This principle, which is called the Corporate Opportunity Doctrine, provides that a director breaches his or her duty when the corporation has a prior claim to a business opportunity and the director usurps (takes) that opportunity.

¹ Note: The term "director" as used throughout this Primer includes the individual members of a governing board of a nonprofit corporation, regardless of whether they are called directors or trustees. In addition, the term "nonprofit" also is generally used to mean tax-exempt for federal tax purposes.

- b. **Conflicts of Interest.** A director who has a conflict of interest, does not disclose it, and participates in a decision that benefits the director directly or indirectly has violated the duty of loyalty.
 - c. **Confidentiality.** Directors must keep the corporation's private information confidential. Directors have access to confidential information about corporate matters and plans and "should not, in the regular course of business, disclose information about the corporation's legitimate activities unless they are already known by the public or are a matter of public record." ABA GUIDEBOOK at 34.
 - ◆ Directors and officers are obligated to use reasonable diligence to "protect and safeguard" corporate information. WILLIAM E. KNEPPER AND DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS, 4-23, p. 165 (6th ed. 1998).
 - ◆ A director may have private information about one company that is crucial to another organization of which he or she is also a director. The director generally may not reveal the information, participate in action at the second organization, or disclose the basis of his or her conflict without breaching his or her duty to the first.
 - ◆ Each corporation should have a policy about confidentiality in addition to a policy on conflicts of interest.
 - d. The duty of loyalty "requires that a director be conscious of the potential for [conflicts of interest] and act with candor and care in dealing with such situations." ABA GUIDEBOOK, *supra* at 30.
- 3. **Duty of Obedience.** Directors are required to act within the bounds of the law generally, and with the intent of achieving the organization's "mission," as expressed in its charter and bylaws.
- C. **State Statutes.** Connecticut has statutes that define how a director is expected to act and conflicting interest transactions.
 - 1. **Standard of Care.** Section 33-1104(a) of the Connecticut General Statutes defines the standard of care required of a director of a nonprofit corporation.
 - a. The statute provides that directors are required to discharge their duties as a director:
 - ◆ In good faith; and

- ♦ With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
 - ♦ In a manner the director reasonably believes to be in the best interests of the corporation.
- b. Section 33-1104(b) provides that a director is entitled to rely on information, opinions, reports, or statements prepared by officers, employees, legal counsel and others if the director reasonably believes the individuals providing the information are reliable and competent.
 - c. A director who performs his or her duties consistent with this standard will not be liable for his action (or inaction). C.G.S. §33-1104(d).
2. **Conflicting Interest Transaction.** Like other states, Connecticut has statutes that define and govern what is required when a director (or a family member) has a significant personal interest in a transaction or decision of a corporation. C.G.S. §§33-1127 through 33-1130.
- a. These statutes provide that the director should not participate in the vote and also generally outline the procedures the corporation may use to obtain effective action on the transaction even though a director has a conflict.
 - b. The statutes apply to a much narrower group of transactions and relationships than a typical conflict of interest policy for a nonprofit corporation.
3. **Miscellaneous.** The Connecticut Uniform Management of Institutional Funds Act (“CUMIFA”) contains a standard for required board behavior with respect to charitable funds. C.G.S. §45a-532. CUMIFA incorporates the Connecticut Uniform Prudent Investor Act (“CUPIA”) and its standard of care. C.G.S. §§ 45a-541 through 541l.
- D. **Section 501(c)(3) Organizations.** Directors of corporations that are exempt under section 501(c)(3) of the Code are subject to special rules and restrictions. These restrictions indirectly define what conduct is required of directors.
1. **Basic Exemption Requirements.** The basic exemption language in section 501(c)(3) of the Code explicitly provides that a corporation, trust, or association may qualify for exemption only if, among other things, "no part of its net earnings inures to the benefit" of any private individual. This proscription is generally viewed as having two components.

- a. "Inurement" occurs when an insider (e.g., a director, a top manager, or a major donor) obtains a benefit or something of value from the organization and does not give fair value in return. The insider must have the ability to substantially influence the organization. Inurement is the basis for revocation of exemption.
 - b. "Private benefit" occurs when an individual (not an insider) receives more than an incidental benefit from a transaction or arrangement with the organization and the individual has not given fair market value for that transaction or benefit.
2. **Intermediate Sanctions.**² Effective for transactions or financial relationships occurring on or after September 15, 1995, the IRS may assess "intermediate sanctions", or federal penalty excise taxes, on individuals who receive, or approve transactions conferring, private inurement. The sanctions, which are discussed in Section IV, will apply in cases of excessive compensation or other transactions in which an insider (including a director) receives an economic value greater than the value provided.

III. CONFLICTS OF INTEREST

- A. **Importance of Conflicts of Interest.** Inattention to or disregard of conflicts of interest has significantly contributed to the recent corporate fiascos. Failure of a board to understand conflicts of interest and to manage them is a recipe for governance problems.
- B. **Scope of the Term "Conflict of Interest".** Although the term "conflict of interest" has a narrow technical meaning, the term commonly describes a number of situations in which an individual has conflicting loyalties or interests.
- 1. The term "conflict of interest" technically refers to a situation in which a director or employee has a material personal interest in a proposed contract or transaction to which the corporation may be a party.
 - 2. The term "conflict of interest" is now used also to address situations in which a director or employee has fiduciary or other obligations to more than one organization (or to an organization and an individual such as a family member) and those obligations conflict.
 - a. These conflicts typically arise when an individual has a duty of loyalty to two organizations, a matter arises at one organization that could affect the interests of the second, and the decision of the first organization would either hurt or help the second organization. The director cannot participate in the decision at the first organization because of his or her duties to the second.

² These rules also apply to section 501(c)(4) organizations.

- b. A frequent solution to this dilemma is non-participation by the director or employee in any actions or matters that might affect the other organization or family member.
 - c. If the conflicts between the duties are frequent and intense, the solution may be for the director or employee to resign.
- 3. For purposes of this Primer, traditional conflicts of interest as well as tensions caused by conflicting loyalties to organizations (or to an organization and a family member) are addressed, and except in those cases in which a pure "conflict of interest" is addressed, the term will be used broadly.

C. **Organizational Management of Conflicts of Interest.** The existence of a conflict of interest is not inherently illegal or improper, and the existence of a conflict does not reflect on the integrity of the individual with the conflict.

- 1. Conflicts are inherent, for example, in trade association boards or network boards.
- 2. In many cases, the strengths that an individual director brings to the board flow from other interests or experience that the director may have.
- 3. The issue is how conflicts of interest are in fact identified and managed.
- 4. The development by a board of effective mechanisms and policies to identify and manage conflicts is critical. Annual disclosure, annual board orientation, and periodic monitoring of disclosures contribute to effective management.

D. **How Conflicts Arise**

- 1. **Personal Financial Interest.** Classic conflicts of interest arise when a director or a close relative of a director has an ownership interest in (or employment relationship with) another entity proposing to do business with the corporation, or when a top employee uses his influence to extract excessive compensation or benefits from the corporation.
 - a. **Sibley Hospital Case.** The landmark case illustrating the first situation is Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, 381 F.Supp. 1003 (D.D.C. 1974).
 - ◆ This was a class action against the directors of the Hospital, banks, and nominally Sibley Hospital itself in which the Hospital's patients alleged, among other things, breaches of duty by the directors. The claims included mismanagement, nonmanagement, and self-dealing.

- Substantial amounts of the Hospital's liquid assets were invested in savings and checking accounts at banks with which the directors were affiliated and drew little or no interest. The Hospital directors were variously directors, employees, and shareholders of the banks.
 - The Hospital directors did not disclose their relationships with these institutions to the Hospital's Board.
 - The Investment and Finance Committees of the Hospital Board did not meet for years.
- ♦ The directors were found liable for breach of fiduciary duty for, among other things, failing to make full disclosure of their interests.
- b. **Desert Hospital.** In another notable case two physician-directors of Desert Hospital in Palm Springs, California took proprietary information and used it to establish their own businesses in direct competition with proposed ventures of the Hospital.
2. **Director on a Board Representing or at Request of Another Organization.** Directors may be selected by member institutions or other special groups, and this may give rise to special obligations and issues. The law does not yet provide a clear answer on how to address potential conflicts in these situations, although disclosure is usually critical.
3. **Conflicts for Non-director Employees.** Employees who are not directors of a corporation may have conflicts of interest as well.
- a. Employees may have a personal or financial relationship with another entity that competes with the corporation, or seeks to do business with the corporation.
 - b. Employers can reasonably expect that their employees will not act competitively or in an otherwise harmful manner toward them.
 - c. The employee handbook or personnel manual should clearly state each employee's duty of loyalty to the employer.
 - d. A conflict of interest could arise when an employee accepts personal gifts, expensive entertainment or favors from an entity that does business with, or is trying to do business with, the organization. Many organizations have developed policies as part of their compliance programs prohibiting

employees from accepting gifts, favors and entertainment of more than nominal value. Accepting gifts, favors and entertainment from entities seeking referrals of Medicare and Medicaid business could also be construed as a violation of the federal Anti-Kickback law. In fact, the OIG specifically referenced this issue in its compliance guidance for nursing facilities.

4. **Conflicts Arising from Holding Board Positions on Related or Affiliated Entities.**

- a. Board members of one corporation may hold positions on the board of a related or affiliated entity.
- b. Transactions or contracts with the related or affiliated entity may conflict with the corporation's interests.

E. **Tools to Manage Conflicts.**

1. **Conflict of Interest Policies.** Each director should carefully review the conflict of interest policy of the corporation on whose board he sits. These policies usually supplement, and do not replace, applicable state laws governing conflicts of interest.

- a. **IRS Manual.** The IRS has opined that a conflicts of interest policy should include the following provisions:
 - ◆ Disclosure by interested persons of financial interests and all material facts relating thereto;
 - ◆ Procedures for determining whether the financial interest of the interested person may result in a conflict of interest;
 - ◆ Procedures for addressing the conflict of interest after determining that there is a conflict;
 - ◆ Procedures for adequate record keeping. The minutes of the board meetings and all committee meetings should include the names of the persons who disclosed potentially conflicting interests, the nature of the potentially conflicting interests, whether the board determined there was a conflict of interest, the names of all persons present for discussions or votes relating to the transaction or arrangement, the content of these discussions, and a record of the vote;
 - ◆ Procedures ensuring that the policy is distributed to all directors and individuals with board-delegated powers. Each such person

should sign an annual statement that he or she has received a copy of the conflicts of interest policy, has read and understands the policy, agrees to comply with the policy, and understands that the policy applies to all committees and subcommittees having board delegated powers.

IRS EXEMPT ORGANIZATIONS DIVISION, CONTINUING
PROFESSIONAL TECHNICAL INSTRUCTION PROGRAM
TEXTBOOK FOR FY 1997, at 21-22 (1996).

- b. **Disclosure.** Disclosure is a critical element in ensuring conflicts are identified and properly managed.
 - ◆ Generally, disclosure should occur in two situations: annually in a written disclosure (i.e., questionnaire), and whenever a conflict of interest arises (before the board takes action).
 - ◆ At times, a director's fiduciary duty to another person or organization may prevent him or her from disclosing the nature of the conflict. In such cases, the director should at least state that such an interest exists, consider leaving the meeting, or at least abstain from the discussion and not vote thereon." ABA GUIDEBOOK, *supra* at 33.
2. **Awareness.** Directors must be sensitive to any interest they may have in a decision to be made by the board and, as far as possible, recognize the interest prior to the discussion or presentation of the matter before the board. ABA GUIDEBOOK, *supra* at 33.
3. **Compliance.** Conflict of interest questionnaires (and policies) will be useless if directors are not required to return them, there is no mechanism to ensure that directors are appropriately disclosing potential conflicts, there is no person or committee ensuring that conflicts are appropriately disclosed when a potential conflict arises, or no one ensures that conflicts are periodically monitored.
4. **Prophylactic Effect of Compliance with Policies.** Compliance with conflict of interest policies is essential to insuring entitlement to available protection from liability.
 - a. State statutes offering directors protection against liability, including liability to the corporation, generally include some variation of a standard that makes the protection only available if the director acted in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he reasonably believed to be in the best interest of the corporation. If a director (or an associate) receives an improper personal economic gain or if directors negligently

approve an improper transaction with an insider without having and enforcing an effective conflicts policy, the directors may not be protected from personal liability.

- b. Coverage requirements in a typical Directors & Officer insurance ("D&O") policy require directors and officers to meet similar standards of conduct and care to be entitled to be defended and covered by the insurer.
- c. Directors, officers and top management will receive some protection from the imposition of IRS Intermediate Sanctions if, in the case of an insider transaction or financial arrangement, the conflict is identified in advance of board approval, and certain requirements, including outside independent confirmation of the fairness of the value, are met.
- d. Although the Federal Volunteer Protection Act of 1997 offers some liability protection to volunteers, the statute will probably not afford protection to a director defending a claim related to conflict of interest because the Act does not apply to a claim for damages brought by or on behalf of the organization.

IV. INTERMEDIATE SANCTIONS

- A. **Intermediate Sanctions**. Prior to the Taxpayer Bill of Rights 2, the IRS's only weapon against inurement was revocation of an organization's exemption. This was rarely used by the IRS for obvious reasons. Effective for transactions occurring on or after September 15, 1995, however, the IRS may assess "intermediate sanctions", or federal penalty excise taxes, on individuals who actually receive excessively rich economic benefits from a section 501(c)(3) organization or who knowingly approve such benefits.
- 1. Thus, instead of penalizing the organization, intermediate sanctions impose personal excise tax liability on the individuals who actually receive excessively rich economic benefits from a tax-exempt organization or who approve such benefits.
 - 2. The sanctions will apply in cases of excessive compensation or other transactions in which an insider receives an economic value greater than the value provided.
 - 3. The excise tax is applied to the "excess benefit," or the amount in excess of the actual fair market value of the transaction or service. For example, if an asset worth \$100,000 was sold to an insider for \$75,000, the "excess benefit" is \$25,000.
 - a. For the insider, or "disqualified person," who receives the excess benefit, the initial tax is 25% of the excess benefit. If the excess benefit is not corrected/paid back in a certain period, the insider is subject to an

additional tax of 200% of the excess benefit. For example, if the excess benefit was \$25,000, the potential excise tax on the insider is \$56,250 (\$6,250 + \$50,000).

- b. An "organization manager" (which can include a director) who approves or knowingly participates in approval of the transaction or arrangement in question is subject to a 10% excise tax. Thus, if the excess benefit is \$25,000, the organization manager is responsible for a \$2,500 excise tax. This liability is shared jointly among all organization managers who knowingly participate, and the maximum tax is \$10,000.

4. **Disqualified Person.** The statutory term for an insider is "disqualified person" or "DP".

- a. **Statutory Definition.** The Code defines a DP broadly to include any person who at any time in the five years before the transaction was in a position to exercise substantial influence over the affairs of the organization,

- ♦ A member of the family of such a person, or
- ♦ An entity (corporation, partnership, trust, etc.) in which such a person (or family member) controls 35%.

- b. **Individuals Who Automatically Are DPs.** The final Regulations published in 2002 provide that certain individuals, such as voting members of the governing body, presidents, CEOs, COO's, and chief financial officers, are automatically DPs because they are in a position to exercise substantial influence over the affairs of the organization.

- c. **Facts and Circumstance Test.** Whether any other person will be a DP depends on the "facts and circumstances" of the particular situation.

B. **Rebuttable Presumption.** The Regulations establish an important procedure that will create a "rebuttable presumption" that a compensation arrangement is reasonable or a transaction is fair market value. Following the procedure ordinarily protects a director who approves compensation or the transaction from being subject to personal excise tax liability if the compensation or transaction is later found to have conferred an excessive benefit because the director will not have "knowingly" approved the excessive amount.

- 1. The presumption will be established if the following conditions are satisfied.

- a. **Advance Approval.** The compensation or transaction is approved in advance by an authorized body of the tax-exempt organization composed entirely of individuals who do not have a conflict of interest.

- ◆ The Board of Directors is an authorized body. A board committee can also be an authorized body as long as state law permits the committee to act on behalf of the board.
 - ◆ A director or board committee member with a conflict of interest should not participate in any way in the process, and the minutes should document that fact.
- b. **Comparability Data.** The authorized body must obtain and rely upon appropriate data as to comparability prior to making its determination.

- ◆ Appropriate data as to compensation includes:
 - ◆◆ compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions;
 - ◆◆ current compensation surveys compiled by independent firms; and
 - ◆◆ actual written offers from similar institutions competing for the services of the disqualified person.

A small charity with annual gross receipts of less than \$1,000,000 is required to obtain less data.

- ◆ Appropriate data for other transactions includes:
 - ◆◆ current independent appraisals of the value of all property to be transferred; and
 - ◆◆ offers received as part of an open and competitive bidding process.

2. **Documentation.** The authorized body must adequately document the basis for its determination when it makes that determination. The written or electronic records must note:

- a. the terms of the arrangement and the date approved;
- b. the members of the authorized body present during discussion of the arrangement and those who vote on it;
- c. the comparability data used and how it was obtained; and

- d. what actions are taken by anyone who is a member of the authorized body but who has a conflict of interest.

If the three requirements are satisfied, then the IRS may rebut the presumption only if it develops enough contrary evidence to rebut the probative value of the comparability data used.

- C. **Written Opinion.** A board of directors can also reduce its exposure by fully disclosing all facts to an appropriate professional and obtaining a reasoned written opinion with respect to elements of the transaction or arrangement within that professional's expertise.
 1. Obtaining such a written opinion reduces the possibility that a director will be subject to intermediate sanctions because the director will not have "knowingly" approved excessive compensation.
 2. Legal counsel (including in-house counsel), CPAs or accounting firms with expertise in the relevant tax matters, and certain independent valuation experts can issue written opinions.
- D. **Defining Compensation.** "Excessive compensation" is a hot button issue, and boards must take care to consider all forms of compensation when they evaluate reasonableness. Compensation includes all forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments and certain non-cash compensation.
 1. Special rules define when benefits provided under a qualified pension or profit-sharing plan are deemed paid.
 2. Special rules also govern other compensation-related issues including incentive compensation, and care must be exercised to comply with them.
 3. Some incidental compensation may be excluded.

V. THE SARBANES-OXLEY ACT: AUDIT COMMITTEES AND OTHER MATTERS

- A. **Focus of Sarbanes.** Congress designed Sarbanes to correct and prevent a litany of failures of corporate oversight and responsibility in publicly-traded companies.
 1. The primary importance of Sarbanes for nonprofits is its focus on the integrity of the outside audit and auditor independence from clients.
 2. Although most provisions of Sarbanes do not apply to nonprofits, they nonetheless provide excellent guidelines for nonprofits and are becoming the best practices.

3. As noted earlier, the only Sarbanes provisions that apply to nonprofits are those relating to whistleblowers and document destruction.
- B. **Audit Committees.** Sarbanes requires that a board of directors establish an independent and competent Audit Committee.
1. **Composition.** Sarbanes requires that each member must be a director. Each member must also be independent, meaning the member:
 - a. Cannot be management; and
 - b. May not receive compensation directly or indirectly from the corporation, i.e., the member may not have a conflict of interest.
 - c. At least one member of the Audit Committee must be a financial expert.
 2. **Responsibilities of the Committee.** The Audit Committee (and not management) is responsible for hiring the auditors, setting compensation, and overseeing the auditor's activities.
 - a. The Audit Committee should meet with the auditor, review the audit, and make a recommendation to the board, which may also meet auditor.
 - b. The Committee should ask the auditors about a number of subjects, including:
 - ◆ Areas in which the financial practices of the corporation do not meet industry standards,
 - ◆ Whether there were any significant changes in accounting policies or practices from the prior year, and, if so, what were the changes and why were they made?
 - ◆ Whether any contingent liabilities are not reflected,
 - ◆ Whether any related party transactions are reflected, and
 - ◆ Whether there were any disagreements between the auditors and management.
- C. **Auditor Responsibilities.**
1. If the corporation retains the same auditor for a number of years, the lead partner should rotate at least every five years.
 - a. The Audit Committee and the board should consider the pros and cons of retaining/changing auditors periodically.

2. An independent auditor generally should not provide non-audit services such as bookkeeping, financial information systems, fairness opinions, internal audit outsourcing services, and legal services to the corporation.
 - a. The Audit Committee may decide to permit the auditor to provide non-audit services, such as tax services, or to undertake very small engagements.
 - b. This means the auditor may prepare Form 990 for the corporation.
 3. These are mandatory for publicly-traded companies under Sarbanes.
- D. **Insider Transactions.** Sarbanes prohibits loans to directors and officers and requires codes of conduct. These are not new concepts for nonprofits.
1. Most nonprofits do not make loans to directors or top management.
 - ◆ Care should be taken if a loan is made, for example, to help with the purchase of a house. The loan should be commercially reasonable, including having adequate security.
 2. Most nonprofits already have extensive conflict of interest policies and require annual disclosure.
 - ◆ The conflict of interest policy should be reviewed to ensure it extends to top management.
 3. The federal Intermediate Sanctions also already address insider transaction issues.
- E. **Financial Statement Certifications.** Sarbanes requires the CEO and CFO to certify that the financial statements are accurate and fairly present the financial condition of the company. This is not directly applicable to nonprofits.
1. **Form 990.** Form 990s must be signed by an officer, and each CEO and CFO should be comfortable with the accuracy and contents of the corporation's Form 990, which is required to be disclosed to the public.
 2. **Connecticut Filings.** Officers may also need to certify the accuracy of required filings with the Connecticut Department of Consumer Protection for charitable solicitation.
- F. **Whistleblowers.** Sarbane's provision on whistleblowers applies to all corporations and prohibits a corporation from retaliating against an individual who reports suspected illegal activity.
1. Each nonprofit should adopt a policy on complaints that defines a procedure and tells employees how to report suspected problems.

2. Many nonprofits, in particular health care organizations that receive Medicare and Medicaid funds, already have comprehensive “compliance programs” that provide a process for employees to report suspected areas of noncompliance with laws.
- G. **Document Destruction.** Sarbanes also makes it a crime to alter, hide, destroy, or falsify documents to prevent their use in litigation or official proceedings.
1. Each nonprofit corporation should develop comprehensive document retention and destruction policies.
 - a. These may be developed in consultation with the independent auditors.
 - b. The policies should be consistent with all regulatory requirements applicable to the nonprofit.
 - c. Electronic communications and records should be included.
 2. Compliance with document retention and compliance policies is critical.
 3. The policies should provide that document destruction will stop immediately if an investigation commences or is believed to be underway.

VII. PROTECTIONS AGAINST DIRECTOR LIABILITY

- A. **General.** Directors of a nonprofit corporation may be protected from personal liability by several statutes; the nature of the corporation and its tax status will determine which statutes are applicable, and the director’s behavior will usually determine whether the director qualifies for protection under the statute. Directors may also be entitled to be indemnified by the corporation and can obtain additional protection from directors and officers (“D&O”) insurance.
- B. **Connecticut Statutes.**
1. **Standard of Care.** Section 33-1104(d) of the Connecticut General Statutes provides that a director of a nonstock corporation who performs his duties in compliance with the standards stated in §33-1104 (*supra* p.4) will not be “liable for any action taken as a director, or any failure to take any action...”
 2. **State Immunity for Uncompensated Volunteers .** Section 52-557m of the Connecticut General Statutes provides that any person who serves as a director of a nonprofit organization qualified as a tax-exempt organization under Section 501(c) of the Code and who is not compensated for those services shall be immune from civil liability for damage or injury occurring on or after October 1, 1987, resulting from any act, error or omission made in the exercise of the person’s policy or decision-making responsibilities if the person was acting in good faith and within the scope of the person’s official functions and duties,

unless the damage or injury was caused by the reckless, willful or wanton misconduct of the person.

3. **Indemnification**. A director may be entitled to indemnification from the corporation. Sections 33-1116 through 33-1125 of the Connecticut General Statutes define the extent of indemnification a corporation may provide.
 - a. In general, the availability of indemnification will depend both on what is stated in the corporation's certificate of incorporation and on the propriety of the director's conduct.
 - b. The right to indemnification is not particularly useful if the corporation does not have assets or insurance.
4. **Limitation of Liability**. A corporation may limit a director's personal liability to the corporation or its members for damages for breach of duty, to the amount of compensation received by the director during the year of the breach. This limitation must be included in the certificate of incorporation of the corporation. In general, the director will be entitled to protection if his conduct was reasonable and in good faith.

- C. **Federal Immunity for Volunteers**. The federal Volunteer Protection Act of 1997 (42 USC §§14501 through 14505) provides that in general no volunteer of a nonprofit organization or governmental entity shall be liable for harm caused by an act or omission of the volunteer on behalf of the organization if the volunteer was acting within the scope of the volunteer's responsibilities in the organization at the time of the act or omission and the harm was not caused by willful or criminal misconduct, gross negligence, reckless conduct, or a conscious flagrant indifference to the rights or safety of the individual harmed by the volunteer.³

1. The Act does not provide protection against the following:
 - a. Claims arising out of automobile or other vehicular accidents involving the volunteer;
 - b. Claims against a volunteer brought by any nonprofit organization (including but not limited to the organization for which the volunteer is performing volunteer services) or by any governmental agency; or
 - c. Any claim based on the violation of any federal or state civil rights law.

³ The Act also requires that the volunteer be properly licensed, certified, or authorized by the appropriate authorities for the activities or practice in the state in which the harm occurred, where the activities were or practice was undertaken within the scope of the volunteer's responsibilities in the nonprofit organization or governmental entity.

2. The definition of “nonprofit organization” includes two kinds of organizations:
 - a. An organization described in section 501(c)(3) and exempt from tax under section 501(a); and
 - b. Any not-for-profit organization which is organized and conducted for public benefit and operated primarily for charitable, civic, educational, religious, welfare or health purposes and which does not practice any action which constitutes a hate crime...
 3. Directors of organizations qualified under sections 501(c)(6) and 501(c)(7) do not appear to be covered by this statute.
- D. **D&O Coverage.** The existence of a D&O policy that provides coverage both for substantive claims and for the expenses of defense is extremely useful.
1. The corporation itself can obtain this coverage. In addition, some, but not all, personal homeowner and umbrella excess liability policies include coverage for the insured as a director or volunteer. The scope of such protection, or whether any protection is provided at all, will vary from policy to policy.
 2. In many cases, although a D&O policy may cover defense expenses, the policy may provide that the insurance company’s obligation to pay those expenses does not arise until the insured successfully defends the claim or some other event occurs late in the litigation that triggers the obligation to pay expenses.

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