
CORPORATE GOVERNANCE

Sarbanes-Oxley Act Less Applicable To Not-for-Profits

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RECENT SCANDALS in corporate America have resulted in a heightened awareness to corporate governance that is likely to carry over to the not-for-profit sector. Policy changes that have been implemented by for-profit corporations and the requirements imposed by the Sarbanes-Oxley Act of 2002 are now leading some not-for-profits to adopt new corporate governance practices modeled after certain requirements of the act. In addition, state attorneys general are considering legislative initiatives that would require not-for-profits to consider and adopt some of the requirements Sarbanes-Oxley has imposed upon publicly traded corporations. The Department of the Treasury is considering a rule that would require officers of not-for-profits to certify the financial statements that are submitted to the IRS each year.

Sound governance practices and accounting transparency are important goals for not-for-profits. Although the corporate governance scheme that applies to for-profit and not-for-profit corporations is substantially the same, these two types of entities are inherently different. Imposing the requirements of Sarbanes-Oxley, either through statute or by voluntary means, may not be the most effective way to ensure sound governance in the not-for-profit sector.

While both the not-for-profit and the for-profit corporation may be organized as corporations, a for-profit corporation's primary purpose is to maximize shareholder

value while a not-for-profit is prohibited by law from being operated for pecuniary or financial gain.¹ In addition, the composition of for-profit and not-for-profit boards differs in several ways. Perhaps most significantly, the directors of a for-profit entity are compensated for their service and are most often shareholders and as such may benefit directly from making sure that the basic goal of maximizing shareholder value is met.

In contrast, the incentives for service on a not-for-profit board are not financial. Social status and personal satisfaction often come with service on a not-for-profit board. Not-for-profit directors are often recruited based on their ability to give money, get money or provide some other resource or expertise. Many well-known individuals who serve on not-for-profit boards do so to lend their names and give prominence to a cause without becoming actively involved in the organization's activities. This can result in large but inactive not-for-profit boards. Another difference is that for-profit directors tend to be seasoned business people who are drawn upon for their business background, experience and skill. The assumption that a board member has a basic level of business experience and sophistication cannot necessarily be made of a not-for-profit board member.

Applying the Law

While fundamental differences exist between not-for-profit and for-profit corporations, statutes and case law apply substantially the same corporate governance standards to both types of entities. Section 717 of the New York Business Corporation Law requires that a director perform his duties "... in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances..." Similarly, §717 of the New York Not-For-Profit Corporation Law requires directors and officers to discharge the duties of their respective positions "in good faith and with

the degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."

Much like a for-profit corporation, the primary bases for potential claims against not-for-profit directors are breaches of the duties of care and loyalty. In claims for breaches of the duty of care, the trend by courts has been to apply the business judgment rule standard of review to not-for-profit director action.²

While statutes and case law generally hold not-for-profit and for-profit directors to similar accountability standards, some of the rationales behind for-profit governance principles do not apply to not-for-profit corporations. For example, some of the commonly held justifications behind the business judgment rule standard of review are to promote risk-taking, to prevent judicial second-guessing of corporate decision-making, to encourage competent directors to serve and to avoid shareholder management of the corporation. While it is difficult to argue in favor of not-for-profit risk-taking, there are strong public policy arguments for ensuring adequate protection for not-for-profit directors who comport with their duties of care and loyalty. Nevertheless, some have suggested that not-for-profit directors should be held to a higher standard.³

As with the business judgment rule, not all of the rationales underlying the need for certain Sarbanes-Oxley requirements to apply to a publicly traded company apply to the not-for-profit. Sarbanes-Oxley was introduced and passed in an effort to restore the trust of the investing public after widespread corporate abuses resulted in significant losses to shareholders. Since not-for-profits do not have shareholders, the same policy grounds do not exist for them to implement similar measures.

One could assert that the analogous argument in support of implementing Sarbanes-Oxley by not-for-profits is that improvements in transparency enable contributors to educate themselves about the

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fiscal soundness of the corporations that receive their donations. Further, sound public policy dictates that funds that receive a tax benefit should not be wasted on donations to corporations that squander or mismanage such funds. Important as these objectives are, Sarbanes-Oxley may not be the most efficient way to ensure that these goals are met. Additionally, when applying Sarbanes-Oxley principles in the not-for-profit setting, consideration must be given to the haste with which Sarbanes-Oxley was passed, and whether it will have a beneficial impact on for-profit corporate governance remains to be seen.

Current Trend

Notwithstanding the need to proceed cautiously, the current trend by not-for-profit leaders and policy makers has been to seek application of Sarbanes-Oxley to not-for-profits. Drexel University has visibly led the move toward applying some of the requirements Sarbanes-Oxley imposes on publicly traded corporations to the not-for-profit sector. It has imposed rigid standards to ensure the independence of its audit committee, requires its business unit heads to certify its financial reports, prohibits personal loans to employees, has hired PricewaterhouseCoopers to conduct an audit of its internal controls, is reviewing a university-wide code with ethical guidelines for specific functions and requires that a member of its audit committee be a financial expert.

Discussion among other not-for-profits to take similar actions is likely to accelerate. In addition, New York Attorney General Eliot Spitzer has proposed legislation that has since been introduced in the New York State Assembly that would impose upon not-for-profits many of the standards that apply to publicly traded corporations under Sarbanes-Oxley. The IRS has also solicited comments on a proposal to make changes to the forms filed annually by not-for-profits.

Whether the proposals pending will be adopted wholesale by legislatures and other not-for-profits remains to be seen. Some of the common elements to the proposals under consideration by state legislatures, the IRS as well as trade associations advocating best practices for not-for-profit members are set forth below:

- **Certification.** Both the chief executive officer and chief financial officer shall make a personal, knowledge-based

certification with respect to the material accuracy of corporate financial statements, which includes that the report does not contain any untrue statement or material omission, that it fairly presents the organization's financial condition, and that any deficiencies in internal controls and any fraud involving management or other key employees have been disclosed to auditors.

- **Audit Committee.** The audit committee shall be created if it does not exist and shall be responsible for the audit relationship and establish internal financial controls. At least one member of the audit committee must be a financial expert. The audit committee may not be used excessively for non-audit services, and audit committee members may not provide legal, banking, consulting or any other professional services to the corporation. Additionally, mechanisms shall be adopted to make sure the audit relationship is monitored.
- **Internal Controls.** Corporations must provide for whistleblower protection to help identify corporate wrongdoing in the preparation of financial statements.
- **Code of Ethics.** Corporations must create a code of ethics for its senior financial officers and create a set of conflict of interest rules.

Practical Considerations

To impose the Sarbanes-Oxley certification requirements on not-for-profits may be heavy-handed in many cases. Many not-for-profits are leanly staffed and operate on shoestring budgets that do not require extensive internal controls and leave little room for mismanagement or fraud to go unnoticed by a conscientious board of directors. Thorough review and monitoring of an organization's financial statements fall within a director's duty of care, and the safeguards against breach of the director's duty of care that are already in place should be sufficient to ensure that preparation of financial statements has been carefully monitored.

To require not-for-profits above a specified annual revenue or asset level to have an audit committee may be a good idea, particularly since not-for-profits are not always staffed with or run by boards that include accountants or financial experts. Without this expertise, review and consideration of internal controls could be inadvertently

overlooked in the absence of a committee with specific oversight responsibilities. The creation of an audit committee may serve as an additional safeguard that director attention is focused on the audit process. Again, however, for smaller not-for-profits, the benefits of having an audit committee are likely outweighed by the costs of ensuring that the appropriate individuals are available to take on this role.

Applying some of the additional Sarbanes-Oxley requirements on the not-for-profit audit committee may not be practical, however. Requiring at least one member of the audit committee to be a financial expert may make it difficult for not-for-profits to attract competent directors to take on this role, which adds additional responsibilities and risks of liability for an unpaid position. The importance of requiring monitoring of the audit relationship and that audit committee members not provide legal, banking or other professional services may not have the significance in the not-for-profit context that it does in the for-profit context. The types of conflicts that arose in recent corporate scandals involving outside auditors providing financial services who allowed liabilities to be recorded off-balance sheet are less likely to become a significant issue for not-for-profits.

In the question of whether to implement whistleblower protections and codes of ethics for senior financial officers, consideration must be given to whether the same incentives to manipulate financial performance exist in the for-profit and not-for-profit settings. In the for-profit context, manipulation of financial results and other unethical conduct is generally done to suggest financial performance was stronger than it actually was. Incentives to cause such manipulation in the for-profit context may stem largely from the fact that compensation of some financial officers may be tied to the corporation's financial performance. In the not-for-profit context, the financial incentives to manipulate financial statements are certainly less compelling to the extent they exist at all. To implement whistleblower protections and a code of ethics for senior financial officers may be heavy-handed, a drain on resources and of minimal benefit.

With respect to requiring not-for-profits to adopt a set of conflict of interest rules, a not-for-profit director's engagement in conflict of interest transactions is covered by the director's duty of loyalty. Statutory guide-

lines for how to avoid conflict of interest transactions are set forth in §715 of the New York Not-For-Profit Corporation Law. As a matter of good corporate governance, to ensure compliance with §715 and the duty of loyalty, a not-for-profit will want to make sure that directors understand this duty and disclose any conflicts or potential conflicts to the other directors. To require additional requirements beyond those falling under §715 and the case law that has evolved around the duty of loyalty by mandating conflict of interest rules is unnecessary.

Larger Entities

The arguments against imposing on not-for-profits certification requirements, audit committee standards, whistleblower protection, conflict of interest policies and officer codes of ethics are not as strong in the case of larger not-for-profits that are national in scope and function in many ways like commercial entities. This has been acknowledged by some policy makers. For example, the legislation recommended by Mr. Spitzer imposes less onerous certification requirements on not-for-profits with less than \$3 million in assets and which receive less than \$1 million in revenue and support. These organizations would be required to have the president, chief executive officer and the treasurer or the chief financial officer certify that the financial information included in its annual report is fairly presented in all material respects.

Other larger organizations would be required to have the certifying officers attest that the annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements, in light of the circumstances under which such statements were made, not misleading; that the organization maintained internal financial controls and that the signing officers have reviewed the effectiveness of those controls during the prior 90 days; and that the signing officers have disclosed to the corporation's auditors any significant deficiencies in the organization's internal financial controls and any fraud involving management or employees with a significant role in those financial controls.⁴

Other more general factors that need to be considered by decision-makers as they think about adding Sarbanes-Oxley-inspired principles to their governance regimes is whether doing so will make it difficult for

not-for-profits to attract competent officers and directors. Even for-profit directors are balking at the demands of service in the aftermath of Sarbanes-Oxley. A survey conducted by Foley and Lardner of the impact Sarbanes-Oxley compliance is having on mid-sized companies shows that since the bill passed, director service requires approximately 200 hours per year. This compares with a time commitment of approximately 125 hours per year prior to Sarbanes-Oxley. The increased time commitment and other strains of compliance are resulting in director resignations, especially for smaller companies.⁵

Another important consideration to be made regarding application of Sarbanes-Oxley to the not-for-profit is whether the costs of doing so justify its benefits. One study of the impact Sarbanes-Oxley compliance is having on medium-sized publicly traded companies has been approximately \$1.2 million.⁶ The cost of running an audit alone has been estimated at approximately \$7,000 to \$10,000 for a not-for-profit with assets valued at \$250,000, almost 4 percent, which is rather a large percentage for just one piece of overall compliance, especially considering that legislation is now pending in Congress that would require foundations to spend at least 5 percent of their annual operating budgets on charitable purposes.⁷

Imposing requirements of Sarbanes-Oxley to the not-for-profit could result in these organizations spending more resources on compliance than they do on actual programs. As another example of Sarbanes-Oxley concerns overtaxing not-for-profit resources, the treasurer of Loyola College noted that the trustees of one higher learning institution opted to table their strategic planning to focus on Sarbanes-Oxley and lost a year of their strategic planning process as a result.⁸

Costs and Benefits

Given fundamental differences between the for-profit and the not-for-profit corporation, a general argument against less, not more, regulation of the not-for-profit can be made. Since contributions of time and money to not-for-profits are voluntary, to some extent, not-for-profits are regulated by market forces. Incentives to make contributions and provide volunteer service do not exist for a not-for-profit with a

history of mismanagement. To ensure that funds can be raised successfully and that competent directors and volunteers will be drawn to serve a not-for-profit, it has strong motives to maintain sound governance practices and avoid public scandal.

That the current focus on enhanced corporate governance practices by corporations is likely to cause not-for-profits to take a closer look at how they are governed and what improvements can be made is very likely a good thing. In so doing, not-for-profit decision makers need to be careful not to feel pressure to model enhanced corporate governance procedures after the requirements Sarbanes-Oxley is imposing on for-profit corporations without carefully considering whether they make good sense in the not-for-profit context.

Particular consideration needs to be given to whether the costs of adopting Sarbanes-Oxley-inspired procedures justify the benefits to not-for-profits or merely taxes already limited resources; whether onerous governance requirements will result in difficulties attracting competent board members and officers to serve; and whether the corporate governance scheme that already exists for not-for-profits adequately covers the issues Sarbanes-Oxley is seeking to address.



(1) New York Not-For-Profit Corp. Law §102(5).

(2) James J. Fishman, *Fiduciary Responsibilities*, presented at the Association of the Bar of the City of New York, June 18, 2003.

(3) Denise Ping Lee, "The Business Judgment Rule: Should It Protect NonProfit Directors?" 103 COLUMB. L. REV. 925, 944-45 (2003).

(4) S.4836—A, 2003-2004 Reg. Sess. (N.Y.).

(5) Conversation with Steven Barth of Foley & Lardner regarding Sarbanes-Oxley survey results, Sept. 9, 2003.

(6) Kimmel, Lance John and Vazquez, Steven W., *The Increased Financial and Non-Financial Cost of Staying Public*, presented at the 2003 National Directors Institute, April 23, 2003.

(7) Jeff Jones, "N.Y.'s Attorney General Seeking to Apply Sarbanes-Oxley Act," *The Nonprofit Times*, March 1, 2003. H.R. 7, 108th Cong. (2003).

(8) John L. Pulley, "Drexel University Adopts Provisions of a Tough New Corporate Financial Reporting Law, but Skeptics Warn Colleges Against Moving Too Fast," *The Chronicle of Higher Education*, June 13, 2003.

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