



# THE SARBANES-OXLEY ACT AND NONPROFITS: “But I Thought That Didn’t Apply to Us”

*Do you have these crucial elements in place in your organization?*

BY SHELDON WHITEHOUSE

**E**very nonprofit has board members who in their business lives are coping with the requirements of the Sarbanes-Oxley Act. We know it’s out there. What does this law mean to you as a nonprofit board member?

Congress passed the Sarbanes-Oxley Act (technically named the American Competitiveness and Corporate Accountability Act of 2002) in the wake of corporate misdeeds that harmed shareholders, employees, and retirees. The Act has stepped onto the landscape of corporate law as a new colossus. The new law, and the regulations the Securities and Exchange Commission has adopted to enforce it, cast a long shadow: requiring publicly traded companies to follow significant new internal governance requirements; expanding whistleblower protection and document-retention requirements; and attacking conflicts of interest in corporate accounting.

Nonprofits aren’t directly subject to the Sarbanes-Oxley Act, unless they violate its whistleblower and document-retention provisions. The bulk of Sarbanes-Oxley’s requirements apply only to public companies (those with securities registered under Section 12 of the Exchange Act, or those required to file reports under Section 15(d) of the Exchange Act or SEC Registration Statements). At the state level, legislation has been proposed—but not passed—in New York, California, and Massachusetts to extend Sarbanes-Oxley-type protections in the nonprofit arena.

## What’s the Real Question?

The conclusion that nonprofits aren’t generally subject to Sarbanes-Oxley requirements doesn’t end the inquiry, however. Nonprofit boards are always subject to a fiduciary’s “due dili-

gence” and “prudent management” requirements, enforceable by regulatory action by state attorneys general, by private lawsuits, or by the Internal Revenue Service’s oversight.

The proper question for nonprofit management isn’t whether Sarbanes-Oxley legally applies to nonprofits but, rather, what elements of Sarbanes-Oxley it would be “prudent” to adopt, even though they may not be directly mandated.

## What Governance Guidelines Pertain?

Bear in mind that Sarbanes-Oxley is just one example of a group of principles gaining expression through a global corporate governance movement. At home, related guidelines reside in the following:

- the Uniform Prudent Investor Act
- the New York Stock Exchange and NASDAQ Corporate Governance Rules
- the American Bar Association’s Report of the Task Force on Corporate Responsibility
- Investor Protection Principles and Mutual Fund Protection Principles of California State Treasurer Phil Angelides
- U.S. Sentencing Guidelines and Department of Justice Prosecution Guidelines
- model policies from the Foundation for Fiduciary Studies
- numerous governance advisories from major accounting firms and other groups.

Abroad, these same principles find expression in such sources as:



## *The magic words are disclosure, disclosure, and disclosure.*

- the Organization for Economic Corporation and Development's Guidelines and Principles for Pension Fund Governance
- the International Corporate Governance Network's "Principles."

Nonprofits with substantial charitable funds under their control would also be well advised to consider governance ideas from:

- the Uniform Management of Public and Employee Retirement Systems Act
- the U.S. Department of Labor's Advisory Council on Employee Welfare and Pension Benefit Plans.

### What Should You Do?

Until the law in the area of nonprofit governance settles a bit further, there is no single and clear source of guidance. Nonprofits' differing purposes, sizes, and responsibilities mean no one set of rules will fit all, even once the law settles. Prudent nonprofit managers will review a variety of sources and adapt appropriate policies. But the larger message should be clear: There is a sea change in expectations for governance of all organizations, and nonprofits must decide what response to this sea change is prudent.

Sarbanes-Oxley is an obvious benchmark. Some Sarbanes-Oxley requirements fall into the "Why not?" category: Unless you can say specifically why you *shouldn't*, then you *should* follow them. These requirements include the following:

**Ethics Statement:** Every nonprofit should adopt an ethics statement. There are eight or ten key areas that can be extracted from the guidelines mentioned above, and you should address all the relevant ones for your organization. Create a written ethics policy, and update it as appropriate. Be sure all board members read and sign your statement when they join the board and regularly thereafter. It wouldn't hurt to have the signed statement also aver that the director has no criminal record or record of bankruptcy.

**Conflict of Interest Policy:** Every nonprofit should also adopt a thorough conflict of interest policy and disclosure procedure. This is critical. The "prudent manager" rule provides ample protection to board decisions—until it is shown that the board was operating under a conflict of interest. Then the rules change, and in effect it becomes the board's burden to show that

the decision was both proper and not influenced by the conflict. Conflicts of interest also raise the hazard that the IRS can jump in and take away favorable tax status. Conflicts of interest should be identified and, unless reviewed and approved through appropriate reporting and recusal procedures, conflicts should be forbidden and sanctioned even-handedly and without exception. The magic words are disclosure, disclosure, and disclosure. Loans to directors or senior staff should be forbidden in this policy.

**Audit Review:** Many nonprofits are large enough to have annual outside audits, and they should establish audit committees that meet Sarbanes-Oxley's independence and expertise standards. Board members should not be part of the audit committee, and at least one member of the committee must be a financial expert. Nonprofits should also consider rotating their outside auditors every five years or so.

**Certified Financials:** Although the legal consequences of CEOs' and CFOs' certification of corporate financial statements don't translate to nonprofit executives, the executive directors of major nonprofits should nevertheless be expected to sign off to the board on the financial statements, and the board should understand, review, and approve the IRS Form 990 through appropriate committees. The board should assure that appropriate disclosures are required as a matter of policy.

**Education:** Boards should adopt education policies for board members. These policies should spell out board members' fiduciary and governance obligations and the financial expertise necessary to make prudent decisions for that particular nonprofit.

**Whistleblowers:** Nonprofit boards should establish a safe and appropriate way for whistleblowers to identify problems to management and to the nonprofit's counsel. Equally important, the whistleblower procedure that is established must be made known to staff. A policy of non-retaliation should be formally adopted and carefully followed, and again the staff must know of it. The larger the organization, the more important and valuable this policy will be.

**Document Retention:** Policies for the retention and destruction of documents should be adopted, and the policy should also protect the privacy of confidential information. Nonprofits may have access to personal financial or medical information or proprietary business information, and that information is held in trust as much as any fiduciary asset.



THE HISTORICAL PRESERVATION SOCIETY THAT  
**WOULD LOVE EASIER  
FUNDRAISING SOFTWARE,**  
BUT WE'D HAVE TO FIRE HALF OUR STAFF TO AFFORD IT.

 **eTapestry**

Traditional fundraising software means huge upfront and maintenance costs. Our advanced, web-based system drastically reduces those costs—without any compromise in functionality. Contact us, and we'll be glad to show you how. [www.etapestry.com](http://www.etapestry.com) or 888.739.3827



## Board members are fiduciaries, profit or nonprofit.

**Attorneys:** Boards should request from the organization's lawyer a review of the attorney's reporting and disclosure obligations under the Rules of Professional Conduct, and an explanation of the new SEC reporting requirements for attorneys. The board should understand the former and adopt as much of the latter as it considers prudent and wise.

### What Are the Critical Elements?

Prominent and even renowned nonprofits have in recent years been embarrassed by disclosures of mismanagement, misuse of funds, and governance failures. State attorneys general and Congress are ramping up oversight of charitable organizations. Sen. Charles Grassley (R-Iowa), Chair of the Finance Committee, warned in the *New York Times* recently that the committee's staff would be investigating concerns about charitable organizations "over a long period of time," and might even hold Congressional hearings targeting nonprofits. "In Congress," he said, "we need to do more oversight to make sure the checks and balances work and supervise the tax credits we're giving. We give tax deductions for charitable giving, so there's a public policy interest in how the money gets used."

As nonprofit board members, we dread, and we endeavour to prevent, but we must prepare for, the day when something goes wrong in the nonprofit we serve. The fact that Sarbanes-Oxley principles have become the legal benchmark for public corporations, particularly in the context of similar national and global governance standards, suggests that when that bleak day comes, relevant Sarbanes-Oxley principles will be a "pru-

dence" benchmark for nonprofits. Particularly in those nonprofits holding funds or properties in trust for others, the standards must be high. Board members are fiduciaries, profit or nonprofit.

The fundamental common-law duty of a fiduciary was famously described by Justice Cardozo as "not honesty alone, but the punctilio of an honor the most sensitive." Fiduciaries are legally held by courts to a "duty of undivided loyalty." The fiduciary prudence standard has been codified by ERISA as the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of a like character and with like aims."

In practice, the fiduciary standard of care has never been defined with great exactitude, and applying the standard to specific facts leaves considerable room for uncertainty, disagreement, and litigation. However, the law emphasizes the *process* by which fiduciary decisions are made, rather than the eventual outcome. The process elements of Sarbanes-Oxley will reinforce this emphasis. For instance, if a mistake might have been prevented by an independent audit committee, and your nonprofit didn't have an audit committee, then the prudence question becomes the process failure of not having that mechanism in place, rather than the board's judgments about the mistaken decision.

The critical elements of any procedure that fiduciaries follow are that it be done prudently, that it be done with due diligence, and that it avoid conflict of interest. As the Foundation to Fiduciary Studies has said about investment fiduciaries, "Fiduciary liability is not determined by investment performance, but

rather on whether prudent investment practices were followed. It's not whether you win or lose, it's how you play the game." Sarbanes-Oxley now benchmarks how prudent fiduciaries must play the game. ■

### References

- ERISA, 29 USC § 1104(a)(1).
- Meinhard v. Salmon*, 249 NY 458, 464, 164; NE 545, 546 (1928) (Cardoso, J.).
- "Prudent Investment Practices," *Foundation for Fiduciary Studies* (2002) at p. 6.
- Ross, L., *State Attorneys General: Powers and Responsibilities*, at 184 et seq. (1990).



*Attorney Sheldon Whitehouse is a Partner with the Litigation Practice Group of Edwards & Angell, LLP (swhitehouse@EdwardsAngell.com), a national law firm with over 300 attorneys focusing on financial services, private equity, and technology. He is also a former U.S. Attorney and Attorney General of Rhode Island.*

Nonprofit World • Volume 22, Number 5 September/October 2004  
Published by the Society for Nonprofit Organizations  
5820 Canton Center Road, Suite 165, Canton, Michigan 48187  
734-451-3582 • www.snpo.org